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**WOULD GAAP - BASED ACCOUNTING  
PRACTICES  
IMPROVE FINANCIAL MANAGEMENT  
AND DECISION - MAKING IN  
THE DEPARTMENT OF DEFENSE?**

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OCT 11 1990  
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BY  
LUCY BOGAN

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THE AMERICAN UNIVERSITY  
SCHOOL OF PUBLIC AFFAIRS  
IN FULFILLMENT OF THE REQUIREMENT FOR A  
MASTERS DEGREE IN  
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The views, conclusions, and recommendations in this research project report are those of the author, and do not necessarily reflect the official views of the Department of Defense, the Department of the Navy, or The American University.

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Lucy Bogan was born and raised in Maryland, and attended the University of Maryland until she married. After putting her husband through school, while working full time, she continued her education at night. In 1985, she undertook an intense program of study, and by 1987, completed her final 51 hours of undergraduate work, receiving a B.S. in Organizational Behavior from Columbia Union College, Takoma Park, MD. In 1988, she began the American University graduate program in public financial management which she completes in August 1990.

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## LIST OF ABBREVIATIONS

ACP	Asset Capitalization Program
AICPA	American Institute of Certified Public Accountants
ARB	Accounting Research Bulletins
BNA	Bureau of National Affairs
CFO	Chief Financial Officer
CIM	Corporate Information Management
CPA	Certified Public Accountant
D & A	Discussion and Analysis
DMR	Defense Management Report
DOD	Department of Defense
DON	Department of the Navy
FASB	Financial Accounting Standards Board
FEI	Financial Executives Institute
FGRS	Federal Government Reporting Study
FMFIA	Federal Managers Financial Integrity Act of 1982
FTC	Federal Trade Commission
GAAP	Generally Accepted Accounting Principles
GAGAS	Generally Accepted Government Auditing Standards
GAO	General Accounting Office
GASB	Governmental Accounting Standards Board
GFM	Government Furnished Material
GSA	General Services Administration
HUD	Housing and Urban Development
IF	Industrial Fund
IG	Inspector General
IRS	Internal Revenue Service
JFMIP	Joint Financial Management Improvement Program
NCGA	National Council of Governmental Accountants
NIF	Navy Industrial Fund
NIPA	National Income and Product Accounts
NYSE	New York Stock Exchange
NZSA	New Zealand Society of Accountants
OMB	Office of Management and Budget
RMS	Resource Management Systems
SAR	Selected Acquisition Report
SEC	Securities and Exchange Commission
VA	Department of Veterans Affairs

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## EXECUTIVE SUMMARY

The purpose of this paper is to analyze whether the General Accounting Office's (GAO's) proposed initiatives of accounting and financial reporting based on Generally Accepted Accounting Principles (GAAP) would improve financial management and the decision-making in the federal government, specifically in the Department of Defense (DOD).

The primary sources of information for this study were current literature in accounting, budgeting and financial management journals and publications, Congressional hearings, statutes, budgets, governmental reports, textbooks, private sector accounting firm publications, financial management improvement organization publications, and audit reports. Additionally, personal interviews were conducted with both public and private sector accounting, budgeting and financial management professionals in an effort to discern specific examples of how GAO's proposed procedures would assist the federal government in improving decision-making and overall financial management, and to provide further insight into some of the specifics of the more conceptual aspects of the accounting and financial management issues.

My approach was to investigate the current federal government accounting model, based on fund, or cash and obligation accounting, and analyze its effect on financial management and on decision-making. I then analyzed the GAO's approach to financial management reform, concentrating on the GAO's primary focus on financial statements based on Generally Accepted Accounting Principles (GAAP), double entry bookkeeping based on accrual accounting and a standard general ledger, the publication and dissemination of annual financial statements, and an annual financial audit.

In a recent audit report of the Air Force entitled Air Force Does Not Effectively Account for Billions of Dollars of Resources (GAO/AFMD-90-23, February 1990), the GAO stated that the DOD did not adequately control costs and resources, did not provide a true accounting for assets, and did not use financial information to make decisions. The GAO recommended that, in addition to improving internal controls, the majority of these problems could be corrected by instituting an integrated double entry general ledger accrual accounting system modeled after that used in private industry based on GAAP. GAO ascertained that such a system would produce financial statements similar to those of private industry based on reliable financial data. Having the ability to produce such statements would promote the discipline needed to improve the DOD financial management system and ultimately the decision-making process.

The type of financial audit done by the GAO of the Air Force was the first such comprehensive financial audit by the GAO of any agency the size of the Air Force, and the first such audit of any of the military services. The Air Force, having volunteered to be the "guinea pig" for the audit at the GAO's request, was dissatisfied with the audit results, stating its accounting system and reporting structure complied with existing Congressional and OMB guidance. The Air Force further stated that GAO's approach amounted to a mirroring of the private sector, and was based on a concept not accepted by Congress or the Executive Branch. Further, the Air Force suggested that the GAO assumed that its concept of improved financial systems would automatically lead to improved decisions without having demonstrated the feasibility of such an assumption. Finally, the Air Force pointed out that the GAO did not indicate how much such a system would cost, nor how it would save money.

I therefore investigated the basis of GAO's arguments and initiatives for federal financial management system reforms, which center on the need for accurate, timely, reliable and consistent data accounted for and presented in a manner similar to that used in the private sector. I reviewed the literature and conducted interviews to determine the specifics of the GAO proposed reforms, as well as the cost/benefit of those reforms.

I found that, although the basic principles, accounting system and reporting structure espoused by GAO as that the Air Force should have had (and that the federal government in general should be following) currently exist in the form of GAO's Title 2,<sup>1</sup> these principles are not followed in the DOD and in the federal government as a whole. Instead, the agencies follow OMB guidance specifying the manner in which appropriation cognizance and control is to be maintained and data is to be reported in the accounting system and to meet the budgeting requirements of the OMB and the Congress.

I then researched the arguments, both for and against GAAP in the federal sector, and determined that, above all, there is confusion regarding the terminology of what GAAP encompasses. When speaking of GAAP, some think only in terms of private sector GAAP as defined by the Financial Accounting Standards Board (FASB); some think of GAAP as defined for state and local governments by the Governmental Accounting Standards Board (GASB); some think in terms of federal GAAP as currently comprised in GAO's Title 2; and some think that, when speaking of the federal sector, a completely new version of federal

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<sup>1</sup> U. S. General Accounting Office. Policy and Procedures Manual for Guidance of Federal Agencies: Title 2 -- Accounting, rev. October 31, 1984.

government GAAP (as recommended by the American Institute of Certified Public Accountants (AICPA)) has yet to be defined.

In investigating both the pros and the cons of GAAP, in general, that is some form of agreed-upon accepted principles and standards to be followed in the federal sector, I found that both sides of the issue had some very convincing points. I found, however, that on the proponent side of the issue, some of the arguments or purported benefits were not well define and lacked a clear demonstration of the proposed benefits. I also found that on the opponent side of the issue, there were some substantive arguments largely centering on the need to realize the uniqueness of the DOD and the federal government as a whole.

I reviewed the proposed alternatives as presented in the literature and the interviews. Although the alternative of the status quo is clearly not an option based on the consensus of opinion by both public and private sector professionals regarding the need for federal financial system improvement, none of the other alternatives should be totally disregarded until thoroughly researched.

I reached the conclusion that, whatever action is taken, federal financial system reforms are necessary to insure reliable, timely, accurate, and consistent financial data. Any reforms, however, must have consensus, and be demonstrable as to their usefulness and necessity to both external and internal users and managers. I also concluded that GAAP (whether FASB, GASB, or Title 2) as currently structured, has not been sufficiently demonstrated as the best approach to financial management system reforms. Finally, I concluded that further research is necessary to determine the best approach to federal financial management system reforms.

I proposed the following recommendations:

1. Conduct a survey of user needs
2. Address the uniqueness of the federal government
3. Examine case studies of GAAP systems
4. Develop specific applications of GAAP data usage
5. Define the degree on system integration desired
6. Develop prototypes of system reforms
7. Conduct cost/benefit analysis of system reforms
8. Develop training courses on system reforms
9. Develop data base showing good practices
10. Develop management reforms
11. Follow due process for standard setting.

## STUDY DESIGN AND METHODOLOGY

The primary sources of information for this study were current literature in accounting, budgeting and financial management journals and publications, Congressional hearings, statutes, budgets, governmental reports, textbooks, private sector accounting firm publications, financial management improvement organization publications, and audit reports. Additionally, personal interviews were conducted with both public and private sector accounting, budgeting and financial management professionals in an effort to discern specific examples of how GAAP-based accrual accounting practices, currently illustrated by GAO's proposed procedures, would assist the federal government in improving decision-making and overall financial management, and to provide further insight into some of the specifics of the more conceptual aspects of the accounting and financial management issues.

Since most of the literature on the GAO proposed reforms was conceptual in nature, interviews were designed to elicit details on how some of the major aspects of GAO's proposed reforms would specifically improve DOD financial decision-making (since a major purpose of providing financial information is to assist in the decision-making process). The questions focused on determining which users of financial information would benefit most from the proposed reforms, and whether any specific consideration was given as to the cost involved in instituting the reforms. Specific questions were as follows:

1. Do you think that the private sector GAAP-based accounting practices proposed by GAO for implementation in the public sector have relevance in the federal government?
2. What specific kinds of information would a GAAP-based accrual accounting system provide to assist a decision-maker that is not currently provided by cash and obligation accounting? Can you give specific examples?<sup>2</sup>
3. Have you seen, or do you know of any examples or studies, etc. comparing and contrasting the specific

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<sup>2</sup> I used as an example of the specific type of example I was seeking: In buying an aircraft carrier, what kind of information would be provided from a GAAP-based system that is not already provided by the current federal cash/obligation-based system that would assist the decision-maker in deciding whether or not to make such a purchase?

kind of information provided by GAAP-based accrual accounting systems with that provided by cash/obligation-based accounting systems?

4. Are you aware of any cost/benefit analysis done on converting federal systems from cash/obligation accounting to GAAP-basis accounting?

My approach was to investigate via literature and interviews, the current federal accounting model as structured in the Department of Defense (DOD) and the Department of the Navy (DON), and analyze its effect on financial management and decision-making. I then analyzed the GAO's approach to financial management reform, concentrating on the GAO's primary focus on financial statements based on GAAP, double entry bookkeeping based on accrual accounting and a standard general ledger, annual financial statements (including the effect the data produced from such proposed systems would have on day to day operating decisions), and an annual financial audit.

After comprehensive research, I analyzed and presented the arguments both for and against the GAO proposed GAAP-based financial reforms. After consideration of all arguments, I presented the proposed alternatives, drew conclusions, and provided recommendations.

## INTRODUCTION

### PURPOSE

The purpose of this paper is to analyze whether the General Accounting Office's (GAO's) proposed initiatives of accounting and financial reporting based on Generally Accepted Accounting Principles (GAAP) would improve the financial management and decision-making in the federal government, specifically in the Department of Defense (DOD).

### BACKGROUND

The question of whether financial systems in the DOD are out of control and causing a loss of taxpayer dollars has recently been highlighted in the press because of GAO's recent audit of the Air Force's financial systems.<sup>3</sup> The Air Force agreed to cooperate with the GAO in being the first DOD military service to attempt to produce auditable financial statements in the manner of GAAP-based private sector financial statements. As a result of this audit, the GAO ruled that the Air Force's financial management system was "unauditable" because of poor data and lack of an integrated general ledger system. In essence, the GAO said that the Air Force was a financial management nightmare because it did not account for costs and resources, or could not produce financial data in the manner of the private sector. Of particular significance is that GAO has proposed instituting an accounting system that was originally mandated by law 40 years ago,<sup>4</sup> but which has never been fully implemented in its intended state.<sup>5</sup>

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<sup>3</sup> U. S. General Accounting Office. Air Force Does Not Effectively Account for Billions of Dollars of Resources, Financial Audit, Report to the Congress, GAO/AFMD-90-23, February 1990.

<sup>4</sup> Budget and Accounting Procedures Act of 1950, September 12, 1950, c. 946, 64 Stat 832.

<sup>5</sup> U. S. Congress. House. Progress and Problems Relating to Improvement of Federal Agency Accounting Systems as of December 31, 1968. Committee on Government Operations. Report to the Congress by the Comptroller General of the United States, December 1969, is the first comprehensive assessment of federal agency compliance with the Budget and Accounting Procedures Act of 1950 and the act as amended in 1956. In the opening letter in the report, John S. Monagan, the chairman of the Committee on Government Operations, indicated that the report showed significant progress in improving federal agency accounting  
(continued...)



## PROBLEM

One of the primary documents issued by the GAO detailing its analysis of federal financial management systems<sup>6</sup> features the following April 1802 Thomas Jefferson quotation on its inside cover:

I think it an object of great importance...to simplify our system of finance, and to bring it within the comprehension of every member of Congress...the whole system [has been] involved in impenetrable fog. [T]here is a point...on which I should wish to keep my eye...a simplification of the form of accounts...so as to bring everything to a single centre[;] we might hope to see the finances of the Union as clear and intelligible as a merchant's books, so that every member of Congress, and every man of any mind in the Union, should be able to comprehend them to investigate abuses, and consequently to control them.

In the preface of the same document, Comptroller General Charles A. Bowsher states that the "situation lamented by Thomas Jefferson has worsened immeasurably" because of the "elaborate structure of decision process and information systems" in the federal arena.<sup>7</sup> Mr. Bowsher indicates that there is an annual search for consensus on the budget which entails costs in time, energy and public confidence. He states that the difficulties associated with this effort could be rectified by a rebuilding of the government's financial management structure. He further proposes that in updating the financial management structure, changes should be made that would improve budget decision-making and would "ensure that congressional and executive branch officials receive timely, reliable, and consistent information with which to make those decisions."<sup>8</sup> Mr. Bowsher closes the preface by stating that, although an ambitious goal, rebuilding

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<sup>5</sup>(...continued)  
systems, however it also showed "continuing procrastination." Virtually none of the federal agency systems was in complete compliance with the act.

<sup>6</sup> U. S. General Accounting Office. Managing the Cost of Government: Building an Effective Financial Management Structure, Major Issues, Vol. I, February 1985, GAO/AFMD-85-35.

<sup>7</sup> Ibid., preface.

<sup>8</sup> Ibid., preface.

the federal financial management system is an idea that has broad consensus and which the American taxpayer deserves.

In an interview in the Journal of Accountancy a few years ago, Mr. Bowsher reiterated his views on the inadequacy of the federal financial management system. He stated that the current system "isn't giving all the factual information to the decision makers in the way that they need it." He indicated that the federal government should provide budgets and financial statements that are understandable to the public. Mr. Bowsher stated that the creation of the Governmental Accounting Standards Board (GASB) was the right step for bringing state and local governments "into sync", and that he could "see no reason why the federal government's accounting processes should be all that different" from those of state and local governments. In addition, although he alluded to the unique features of such entities as the DOD, he stated that the federal system "should have many of the same standards for operating costs and capitalization that are used by state and local governments." Mr. Bowsher summed up his thoughts on federal financial management systems by stating that "the systems haven't been modernized; the federal government hasn't made the investment in them."<sup>9</sup>

#### GAO'S CONCERNS

The GAO analysis of federal financial management problems centers on five broad categories -- lack of cost information, lack of reliable weapon system information, inadequate disclosure in the budget of costs and liabilities, unstructured planning for capital investment, and antiquated financial management systems.<sup>10</sup> Although this paper will primarily address the last category, the others are discussed at this point because the GAO indicates that updating the federal financial system in conjunction with its proposed reforms will solve the other four categories of problems as well.

#### Lack of Cost Information

The GAO states that the focus in federal accounting systems is on obligation information (when an item is ordered) and outlay information (when the bill is paid). There is no recognition when resources are actually used in operation, therefore, the GAO concludes that there is no consistently reliable measure of

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<sup>9</sup> Collins, Stephen H., and Joseph F. Moraglio. "The Role of the GAO." Journal of Accountancy, April 1987, 58-70.

<sup>10</sup> U. S. General Accounting Office. Managing the Cost of Government: Building and Effective Financial Management Structure, Major Issues, Vol. I, February 1985, GAO/AFMD-85-35.

resources consumed (costs) in carrying our government programs. Budgeting is done in terms of programs and projects, while accounting is done in terms of appropriations and categories of expense. Finally, there is no means to relate budgeting to accounting.<sup>11</sup> According the GAO, these practices do not provide the information necessary to monitor program execution, avoid overruns, and plan and budget effectively.<sup>12</sup>

#### Lack of Reliable Information on Weapon Systems

The GAO states there is a lack of consistent, complete budget and accounting information which means that budget estimates and program management are not well supported. The primary document for reporting weapon system cost is the Selected Acquisition Report (SAR). The data to produce this report are not tied to an accounting system, but come from supporting information systems and contractor produced information. The GAO points out that these costs are often reported differently from year to year, with differences and changes not always clearly identified. Additionally, these costs are not always consistent with those reported in the budget to Congress.<sup>13</sup>

#### Inadequate Disclosure in the Budget of Costs and Liabilities

The GAO notes that not all liabilities are included, e.g. retirement benefits, therefore the true cost of programs and consequences of current actions on those programs are often distorted. In addition, many items are "off-budget", e.g. off-budget loans, Social Security retirement and disability. As a result of these actions, the GAO feels that the true costs of the government's activities are therefore distorted.<sup>14</sup>

#### Unstructured Planning for Capital Investment

The GAO states that the current system treats capital spending in the same manner as it treats operational spending. The budget should contain two separate displays: 1) a capital component which would include new investments, and 2) an

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11 Ibid., pp. 4-5.

12 Ibid., p. 2.

13 Ibid., pp.6-7.

14 Ibid., pp 8-9.

operating component, which would include salaries, utilities, contracted services, and depreciation.<sup>15</sup>

### Antiquated Financial Management Systems

The GAO proposes that the current government data processing technology is out of date. The systems should be designed using a common framework. This could be approached in two different ways: 1) a redesign of the existing systems without altering the basic roles and missions of the agencies (the GAO feels this is not the more efficient choice), or 2) a revision of the basic structure of financial management (the GAO feels that is the more efficient choice). The basic structure revision would include consolidating processing centers for accounting and disbursing, and promoting the sharing of common systems for related functions.<sup>16</sup>

### MEDIA HIGHLIGHTS GAO AUDIT OF THE AIR FORCE

The front pages of the newspapers of February 22, 1990 portrayed what could only be described as a financial manager's worst nightmare:

"AIR FORCE COSTS "GROSSLY UNDERSTATED" "<sup>17</sup>

screamed the front page of the Washington Post.

"GAO BLASTS AIR FORCE FOR FINANCES"<sup>18</sup>

hailed the Washington Times.

The newspaper articles summarized the most sensational findings of the first and largest full-fledged financial audit of one of the largest federal agencies. From the GAO audit entitled

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<sup>15</sup> Ibid., pp. 10-11.

[It has been pointed out to the author, however, that by the very nature of the appropriation structure, the current DOD budget segregates operating appropriations (e.g., operations and maintenance, military personnel) from capital appropriations (e.g., procurement, military construction.)]

<sup>16</sup> Ibid., pp. 12-13.

<sup>17</sup> Moore, Molly. "Air Force Costs 'Grossly Understated'", The Washington Post, February 22, 1990, A-1.

<sup>18</sup> Scarborough, Rowan. "GAO blasts Air Force for finances", The Washington Times, February 22, 1990, 4.

Air Force Does Not Effectively Account for Billions of Dollars of Resources,<sup>19</sup> the newspapers summarized the following:

The Air Force has "grossly understated" costs of major weapon programs by tens of billions of dollars because of inaccurate and unreliable accounting systems...Air Force accounting systems do not provide reliable information of Air Force weapon systems...GAO blamed the problem on an antiquated and inadequate accounting system that does not track the full costs of buying and operating weapons systems.<sup>20</sup>

Congressional auditors have drafted a scathing report on the way the Air Force manages its money, accusing the service of badly underestimating the costs of major weapons and keeping inaccurate financial reports.<sup>21</sup>

The newspapers effectively focused on the main points of the GAO audit which, in draft was entitled Billion Dollar Decisions Made Using Inaccurate and Unreliable Air Force Data. The GAO audit of the Air Force essentially said that Air Force financial systems and practices were obsolete.<sup>22</sup> In addition, because the Air Force was unable to produce credible financial statements, its financial management was "clearly...[in a] poor state."<sup>23</sup>

The GAO audit of the Air Force financial systems reported other findings. These findings included an inadequate standard general ledger system, subsidiary systems that were outside of the financial management system, untimely reporting of and

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<sup>19</sup> U. S. General Accounting Office. Air Force Does Not Effectively Account for Billions of Dollars of Resources, Financial Audit, Report to the Congress, GAO/AFMD-90-23, February 1990.

<sup>20</sup> Moore, Molly. "Air Force Costs 'Grossly Understated'", The Washington Post, February 22, 1990, A-1.

<sup>21</sup> Scarborough, Rowan. "GAO blasts Air Force for finances", The Washington Times, February 22, 1990, p. 4.

<sup>22</sup> U. S. General Accounting Office. Air Force Does Not Effectively Account for Billions of Dollars of Resources, Financial Audit, Report to the Congress, GAO/AFMD-90-23, February 1990, p.21.

<sup>23</sup> Ibid., p. 21.

inaccurate data, unsupported account adjustment entries, understatement of weapons systems costs, unaccountability for government furnished material (GFM), and unaccountability of inventories.<sup>24</sup>

The purpose of this paper, however, is not to debate the specifics of the Air Force audit. The issue to be explored is the GAO's intimation that the problems inherent in the systems audited can be corrected through the process required to produce financial statements. The following excerpts from the GAO audit of the Air Force serve to illustrate GAO's position:

The integrity of these data, the systems that process them, and the resultant internal and external reports can only be relied upon when they are produced by the kind of disciplined process that results from annual independent audits.<sup>25</sup>

The process of generating and accumulating financial information necessary to prepare accurate and meaningful statements instills discipline in the system and strengthens accountability. Financial statement audits ensure that accounting transactions, accounting systems, financial statements, and financial reporting to the Congress, Treasury, the Office of Management and Budget (OMB), and the public are properly linked and consistent.<sup>26</sup>

Audited annual financial statements of federal entities, prepared according to generally accepted accounting principles and standards,<sup>27</sup> are urgently needed to provide useful, reliable information to the Congress, federal managers, and the public in a readily understood format."<sup>28</sup>

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<sup>24</sup> Ibid., pp. 4-6.

<sup>25</sup> Ibid., p. 16.

<sup>26</sup> Ibid., p. 16.

<sup>27</sup> GAO uses a footnote at this point to state that "These are contained in Title 2 ("Accounting Principles and Standards for Federal Agencies") of GAO's Policy and Procedures Manual for Guidance of Federal Agencies.

<sup>28</sup> Ibid., pp. 17.

## INVESTIGATION OF THE PROBLEM

### GAO AUDIT OF THE AIR FORCE FINANCIAL SYSTEMS

The type of audit typically conducted by the GAO (and the DOD and military service internal auditors) is a performance audit. This type of audit focuses on the operational effectiveness of organizations and programs through examination of compliance of programs and operations with existing guidance. In recent years, the GAO has begun conducting financial audits. This type of audit, formerly unique to the private sector and to state and local governments, focuses on an examination of management's financial statements for external reporting. The independent audit yields a rendering of an opinion as to the "fairness" of a financial statement. Four types of opinions are possible: unqualified, qualified, adverse, and a disclaimer.

Several years ago, the GAO decided to undertake an audit of the Air Force's initial financial statements prepared in accordance with generally accepted accounting principles of federal agencies. The Air Force was the only military service which attempted to prepare such financial statements, and was assisted by the GAO in understanding and applying the concepts required to produce the financial statements.

The GAO audit of the Air Force's financial statements was the first comprehensive financial audit undertaken by the GAO of any agency the size of the Air Force, and the first of any of the military services. It took approximately 25,000 staff days to perform, and on a full cost basis, cost approximately \$12 million dollars.<sup>29</sup> At the completion of the audit, the GAO stated that the Air Force financial statements were unauditable, which was essentially an adverse opinion. The Air Force systems were deemed unauditable by the GAO because the systems did not support a general ledger, there were weaknesses in internal controls, and questions about costs of military hardware and valuation of inventories.

In his statement before the House Subcommittee on Readiness hearing regarding the GAO audit of the Air Force, Sean O'Keefe, the DOD Comptroller indicated the following:

In short, we manage funds by appropriation account as approved by Congress. GAO's concern is that the data does not easily translate discretely as expense or asset data to form the basis of a financial statement

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<sup>29</sup> U. S. Congress. House. Air Force Financial Management Systems: Hearing before the Subcommittee on Readiness. Committee on Armed Services. March 8, 1990., pp. 22-23.

comparable to private-sector practice. This does not indicate inaccurate accounting of appropriated dollars."<sup>30</sup>

#### AIR FORCE RESPONSE TO THE GAO ADVERSE OPINION

The Air Force news release of February 1, 1990 stated the following:

GAO's findings are fundamentally misdirected. They compare current Air Force financial systems, which effectively comply with existing Congressional and OMB requirements, to a GAO concept of using auditable balance sheets and other financial statements used by "for-profit" companies. This concept has not been accepted by the Congress or the Executive Branch for DOD application and GAO certainly has not proven these for-profit statements as a needed management tool.<sup>31</sup>

After reviewing the draft of the GAO audit of the Air Force, the Secretary of the Air Force, Donald B. Rice, expressed his dissatisfaction with the results of the GAO audit in a letter to the Comptroller General of the U. S., Charles A. Bowsher. Mr. Rice stated:

The GAO findings are fundamentally misdirected. They compare Air Force financial systems to GAO pre-conceived accounting statement requirements that have not been promulgated for executive branch adoption by the OMB.<sup>32</sup>

Mr. Rice went on to say that in the draft audit report, the GAO makes "frequent assertions about the benefits from financial statements that meet the GAO-self-initiated standard, but presents no evidence to back them up."<sup>33</sup> In addition, Mr. Rice

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<sup>30</sup> O'Keefe, Sean, Comptroller of the Department of Defense, Statement before U. S. Congress. House. Committee on Armed Services. Improving Financial Management in the Department of Defense: Hearing before the Subcommittee on Readiness. Transcript, March 8, 1990, p. 2.

<sup>31</sup> U. S. Department of the Air Force. "GAO Audit, Financial Management: Billion-dollar Decisions Made Using Inaccurate and Unreliable Air Force Data." News Release, February 1, 1990, p. 1.

<sup>32</sup> Rice, Donald B., Secretary of the Air Force, to Charles A. Bowsher, Comptroller General of the U. S., February 15, 1990, p. 1.

<sup>33</sup> Ibid., p. 1.



points out that the GAO does not identify any cost savings, nor any implementation costs which, according to Mr. Rice, are "likely to be in the billions of dollars for the DOD."<sup>34</sup> In defending the Air Force practices of fund accounting and decision-support systems existing outside of the accounting system, Mr. Rice speaks of the guidance which governs federal financial management systems:

Additionally, we must comply with OMB Circular A-127<sup>35</sup> requirements to gather and process financial management data only when necessary to meet specific internal management needs or external requirements, to tailor reports to specific user needs, and terminate reports if usage does not justify costs.<sup>36</sup>

In his letter, Mr. Rice cites the concerns of the DOD Inspector General after reviewing the draft report of the GAO audit. He quotes the DOD Inspector General<sup>37</sup> as stating that the GAO did not take note of existing management systems, and without providing specific support:

"...the GAO assumes that better financial systems will automatically lead to better decisions on the selection of future weapon systems. The GAO also ignores the enormous cost of developing these systems...offers no specific savings...infers from its [the audit report] title that "billions" can be saved."<sup>38</sup>

Additionally, the DOD Inspector General is further quoted as stating that the management of long supply items and inventory "must be managed on a item/inventory basis for readiness and

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<sup>34</sup> Ibid., p. 1.

<sup>35</sup> U. S. Office of Management and Budget, OMB Circular A-127, Financial Management Systems, December 19, 1984.

<sup>36</sup> Rice, Donald B., Secretary of the Air Force, to Charles A. Bowsher, Comptroller General of the U. S., February 15, 1990, p. 2.

<sup>37</sup> In addition, in a separate letter to the Secretary of Defense, the DOD IG stated that "the premise on which the audit was conducted has not been generally accepted as being particularly relevant in the conduct of the Defense mission." Crawford, Susan J., Inspector General of the Department of Defense, to Richard Cheney, Secretary of Defense, February 6, 1990.

<sup>38</sup> Ibid., p. 3.

warfighting purposes--not on the basis of a financial statement."<sup>39 40</sup>

In closing, the Secretary of the Air Force stated that the audit report misrepresented the Air Force financial management systems, and urged the Comptroller General to prepare a report which:

...fairly evaluates the pros and cons of GAO's approach and which uses Air Force data only as a test case for a new approach, while recognizing that Air Force systems comply effectively with existing requirements.<sup>41</sup>

#### GAO COMMENTS

In his response to the Secretary of the Air Force, Mr. Bowsher indicated that GAO evaluated the Air Force based upon OMB, Department of the Treasury and GAO system requirements. He indicated that the GAO was familiar with the other sources of decision-making information that exist outside of the accounting system, but indicated that they are "far from accurate and complete."<sup>42</sup> Mr. Bowsher reiterated the GAO position on the importance of financial statements:

Integrated accounting systems install discipline and promote accountability...When concern is lacking about preparation of year-end financial statements that meet accepted accounting standards, and which are capable of withstanding periodic audit, the temptation will inevitably arise to 'plug' financial discrepancies with faulty numbers..."<sup>43</sup>

Mr. Bowsher did not address the issues of the costs and benefits of the financial statement approach to financial management.

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<sup>39</sup> Ibid., p. 3.

<sup>40</sup> Although it may be obvious to accountants that a financial statement would not be beneficial in making such decisions, this fact is not immediately apparent to non-accountants. The demonstration of the specific usefulness of a financial statement needs to be made to ensure this confusion is cleared.

<sup>41</sup> Ibid., p. 3.

<sup>42</sup> Bowsher, Charles A., Comptroller General of the U. S., to Donald B. Rice, Secretary of the Air Force, March 8, 1990, p. 2.

<sup>43</sup> Ibid., pp. 2-3.

## GAO'S BASIC REQUIREMENTS

As highlighted by the GAO financial audit of the Air Force, the main means of corrective action of financial management problems are 1.) financial statements based upon generally accepted accounting principles, 2.) double entry bookkeeping based upon a standard general ledger system, and 3.) annual financial audits.<sup>44</sup> Mr. Bowsher underscored these measures when questioned by Mr. Waters, a staffer for the Readiness Committee, at the hearings on the Air Force audit before the House Subcommittee on Readiness. Mr. Waters, in following up on a question regarding the nature of the action necessary to correct errors in the Air Force financial systems asked Mr. Bowsher if "what GAO is recommending, is financial statement[s] supported by double entry accounting and an annual financial audit" to which Mr. Bowsher answered in the affirmative.<sup>45</sup>

This basic approach to financial management reform is further documented in other GAO reports. For example, in their fourth and latest report on federal efforts related to the Financial Managers Financial Integrity Act of 1982, GAO encourages Congress to enact legislation that would establish a national Chief Financial Officer (CFO), establish agency CFO's, and "require the annual preparation and audit of agency financial statements."<sup>46</sup> The Comptroller General has further emphasized the GAO approach to financial management in articles in the current literature. In an article in the Public Administration Review, Mr. Bowsher stated that "consistent, comparable data from integrated financial systems is essential for preparing government-wide financial statements. These statements can supplement budgeting and accounting information by giving an overall picture of the financial health of the government that is

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<sup>44</sup> U. S. General Accounting Office. Air Force Does Not Effectively Account for Billions of Dollars of Resources, Financial Audit, Report to the Congress, GAO/AFMD-90-23, February 1990, p. 16-17.

<sup>45</sup> U. S. Congress. House. Air Force Financial Management Systems: Hearing before the Subcommittee on Readiness. Committee on Armed Services. Transcript, March 8, 1990, p. 66.

<sup>46</sup> U. S. General Accounting Office. Inadequate Controls Result in Ineffective Federal Programs and Billions in Losses, Financial Integrity Act, Report to Congress, GAO/AFMD-90-10, November 1989.

not available elsewhere."<sup>47</sup> He further stated that "financial auditing enhances the oversight of programs by providing a better basis for selecting areas for program audit and evaluation."<sup>48</sup>

#### HISTORY OF FEDERAL ACCOUNTING AND BUDGETING REQUIREMENTS

The foundation for federal accounting has its roots in the Constitution which states that "no money shall be drawn from the Treasury, but in Consequence of Appropriations made by Law."<sup>49</sup> The need to relate all financial transactions to specific appropriations requires that fund accounting be performed to ensure agencies maintain an integrated system of accounts. In addition, agencies must control their stewardship of all funds and appropriations for which they have responsibility. Further, the limit on the amount that may be obligated by federal agencies is set by the appropriation for a particular year.<sup>50</sup>

In the area of appropriation-driven accounting policy, probably the most quoted, and most closely monitored, of all financial legislation is the Antideficiency Act.<sup>51</sup> The purpose of this legislation, dating back to 1870, was to prevent agencies from having obligations and expenditures in excess of amounts appropriated by the Congress. Each agency was directed to have a simplified system of subdividing appropriations among operating units, with the objective of maintaining control at the highest practical level within the agency. The implementation of this act has generally resulted in the design of detailed systems of authorization and fund certification.

Broad changes were made in federal financial management with the passage of the Budget and Accounting Act of 1921.<sup>52</sup> The act gave the Comptroller General the power to prescribe the forms, systems, and procedures for the administrative control and accounting for funds appropriated to the various agencies.

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<sup>47</sup> Bowsher, Charles A. "Sound Financial Management: A Federal Manager's Perspective." Public Administration Review, January/February 1985, p. 183.

<sup>48</sup> Ibid., p. 183.

<sup>49</sup> U. S. Constitution, Article 1, Sec. 9, Cl. 7.

<sup>50</sup> Tierney, Cornelius E. Handbook of Federal Accounting Practices, Reading, MA: Addison-Wesley Publishing Co., 1982, p. 7.

<sup>51</sup> Antideficiency Act. Sec. 3679 of the Revised Statutes.

<sup>52</sup> Budget and Accounting Act of 1921.

The Budget and Accounting Procedures Act of 1950<sup>53</sup> directed the Comptroller General of the United States to prescribe accounting principles and standards to be observed by federal agencies and departments.<sup>54</sup> The impetus for this law was the need to streamline a complex system of accounting that had not kept pace with a rapidly growing government. There was a need to reduce the number of appropriations, and to eliminate the deficiency appropriation.<sup>55</sup> In addition, the act was designed to simplify the complex warrant and requisition system.<sup>56</sup>

The principles of the Budget and Accounting Procedures Act of 1950 have been published since 1958 in all editions of Title 2 of the GAO's Policy and Procedures Manual for Guidance of Federal Agencies<sup>57</sup>. The act began a long history of fragmentation<sup>58</sup> of financial management system responsibilities, and confusion and noncompliance in that the executive agencies were encouraged to develop their own systems that would have to conform to the GAO

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<sup>53</sup> Budget and Accounting Procedures Act of 1950.

<sup>54</sup> Initially, the Comptroller General approved proposals for accounting systems prior to their being instituted. Now, however, "[u]nlike in the past, GAO will now review and approve only accounting systems in operation. Upon request, GAO will provide consultative assistance to executive agencies in the development and operation of their systems to the extent staff resources permit." [This leaves the agencies with wide latitude in systems development, and allows wide diversities in systems among agencies.] Joint Financial Management Improvement Program. Financial Handbook For Federal Executives and Managers, November 1984, p. 19.

<sup>55</sup> U. S. Congress. House. Budget and Accounting Procedures Act of 1950. Report no. 2556 to accompany H. R. 9038, July 1950, p. 2.

<sup>56</sup> U. S. Congress. House. Budget and Accounting Procedures Act of 1950. Committee on Expenditures in the Executive Departments. Hearing on H. R. 9038, July 11, 1950, p. 18.

<sup>57</sup> U. S. General Accounting Office. Policy and Procedures Manual for Guidance of Federal Agencies: Title 2 -- Accounting, rev. October 31, 1984 [and prior editions since 1958].

<sup>58</sup> Susumu Uyeda states in "Federal Financial Management Reorganization -- Points to Ponder." Government Accountants Journal, reprint, p. 7, that financial management policies are distributed among OMB, Treasury, GAO, and, to a lesser extent, GSA and the Office of Personnel Management.

standards and principles, integrate those systems with the Office of Management and Budget's (OMB) budgetary reporting requirements, and integrate those same systems with the Treasury reporting requirements. In addition, "the Treasury, OMB, and individual departments and agencies have disagreed with the GAO over the need for or applicability of a number of the GAO's accounting principles and standards. Inadequate due process and irrelevance of some standards are also cited as reasons for noncompliance...Some of the prescribed standards are perceived to be irrelevant to the unique objectives and environment nature of the federal government."<sup>59</sup>

The Budget and Accounting Procedures Act of 1950 was amended in 1956 by 84 P.L. 863,<sup>60</sup> and each executive agency was required to maintain the accounts of the agency on an accrual basis to show the resources, liabilities, and costs of operations of the agency with a view to facilitating the preparation of cost-based budgets. The accounting principles and standards for the accrual accounting were to be prescribed by the Comptroller General.<sup>61</sup>

The evolution of the various statutes, legislation, and GAO regulations is that each federal agency is required to prepare financial statements reflecting the financial position, results of operations, and the status of individual appropriations. Within this broad framework, every federal agency uses its own design of a financial management system to meet the reporting requirements in official reports to the Treasury, OMB, and Congress. Additionally, all federal agencies must be included in the President's budget, with the federal deficit or surplus being traditionally measured on a cash basis, that is, by the difference between cash revenue and cash expenditures.

In compliance with the Budget and Accounting Procedures Act of 1950, and as amended in 1956, the GAO has defined the accounting principles and standards to be followed by federal agencies in Title 2 of the General Accounting Office Policy and

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<sup>59</sup> American Association of Certified Public Accountants. Federal Financial Management Issues and Solutions, Discussion Memorandum, by the Task Force on Improving Federal Financial Management, 1989, p. 6.

<sup>60</sup> Budget and Accounting Procedures Act of 1950, as amended in 1956, 84 P. L. 863.

<sup>61</sup> In reality, the act is not followed as to a bona fide accrual accounting systems and cost-based budgets.

Procedures Manual for Guidance of Federal Agencies.<sup>62</sup> This manual provides that federal agencies are to have cost-based budgets, and accrual accounting systems. The GAO, an agent of the legislative branch of the government, however, can only prescribe and monitor. The GAO, as an instrument of the legislative branch of the government, has no legal authority to administer the policies it prescribes for implementation in the executive branch of the government.

The Federal Manager's Financial Integrity Act of 1982 (FMFIA)<sup>63</sup> was passed to ensure that accounting and auditing were properly administered. This act amends the Accounting and Auditing Act of 1950 (a part of the Budget and Accounting Procedures Act of 1950) to require each executive agency to evaluate and report on the systems of internal accounting and administrative control and their compliance with Comptroller General standards. The act seeks to ensure obligations and costs are in compliance with the law; funds, property and assets are safeguarded; and revenues and expenditures are properly safeguarded.

The GAO's Standards For Internal Controls In The Federal Government<sup>64</sup> provides the internal control standards to be followed in conjunction with the Accounting and Auditing Act of 1950 and the Federal Manager's Financial Integrity Act of 1982. It provides guidelines on both the program management and the financial management areas of internal control, and is to be used pursuant to the OMB Internal Control Guidelines.

The OMB is the executive branch's agent for administering the financial policies governing federal agencies. The two OMB vehicles for ensuring that both the Budget and Accounting Procedures Act of 1950 and the FMFIA are carried out are OMB Circular A-123, Internal Control Systems,<sup>65</sup> and OMB Circular A-127, Financial Management Systems,<sup>66</sup>

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<sup>62</sup> U. S. General Accounting Office. Policy and Procedures Manual for Guidance of Federal Agencies: Title 2 -- Accounting, rev. October 31, 1984.

<sup>63</sup> Federal Manager's Financial Integrity Act of 1982, P. L. 97-255, 96 Stat. 814, September 8, 1982.

<sup>64</sup> U. S. General Accounting Office. Standards For Internal Controls In The Federal Government, Accounting Series, 1983.

<sup>65</sup> U. S. Office of Management and Budget. OMB Circular A-123, Internal Control Systems, rev. August 4, 1986.

<sup>66</sup> U. S. Office of Management and Budget. OMB Circular A-127, Financial Management Systems, December 19, 1984.

OMB Circular A-123 states that agencies shall maintain cost-effective internal control systems that "provide reasonable assurance"<sup>67</sup> that resources are protected against fraud, waste, and abuse. Objectives of the internal control program are to ensure obligations and costs comply with the law, assets are safeguarded, programs are efficient and effective, and "revenues and expenditures applicable to agency operations are recorded and accounted for properly so that accounts and reliable financial and statistical reports may be prepared and accountability of the assets may be maintained."<sup>68</sup> In a supplement to the 1982 guidelines on internal control, agencies are given latitude in applying the guidelines:

Compliance with the Internal Control Guidelines is not mandatory, provided agencies adopt alternative procedures of equivalent efficacy. These agency procedures must determine relative risk of fraud, abuse, and other losses in agency programs and administrative activities; and also identify and correct material weaknesses in agency internal control systems.<sup>69</sup>

A companion to the OMB Circular A-123 is the OMB's Internal Control Guidelines. This document states that internal control should not be provided by a separate system, but should be integral to the systems used to run an agency's programs and operations. In defining internal control standards, OMB addresses the need for agencies to ensure their system of internal accounting and administrative controls is in compliance with the Comptroller General's standards.<sup>70</sup> OMB further states that its understanding of those standards include the test of reasonable assurance that internal control systems shall:

provide reasonable, but not absolute, assurance that the objectives of the system will be accomplished. This standard recognizes that the cost of internal control should not exceed the benefits derived therefrom, and that the benefits consist of reductions

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<sup>67</sup> U. S. Office of Management and Budget. OMB Circular A-123, Internal Control Systems, rev. August 4, 1986, para. 4.

<sup>68</sup> Ibid., para. 7.

<sup>69</sup> Ibid., Supplement, page 1.

<sup>70</sup> U. S. General Accounting Office. Standards for Internal Controls In the Federal Government, Accounting Series, 1983.



in the risks of failing to achieve the stated objectives.<sup>71</sup>

The internal control guidelines present common event cycles and suggested objectives for internal control. Areas covered are operations cycles, internal management and administrative cycles, information processing and reporting cycles, asset and liability cycles, receipt cycles, and expenditure cycles.<sup>72</sup> Although part of the stated purpose of internal controls is to ensure the agency's internal accounting system is in compliance with GAO standards, nowhere in the OMB guidelines is the structure of the agency accounting system addressed.

OMB Circular A-127, in identifying the requirements of the Budget and Accounting Procedures Act of 1950, state that the responsibility for establishing and maintaining accounting and reporting systems belongs to the executive branch. The Circular further states that in providing full disclosure of financial results, adequate financial information for budget formulation and execution, and control over revenues, expenditures, funds, property, and assets, agency accounting systems shall give "full consideration...to the needs and responsibilities of the Congress and the executive branch in systems design and reporting."<sup>73</sup> The Circular requires the annual FMFIA report to the President and the Congress as to whether each agency's accounting system is in compliance with the principles and standards of the Comptroller General and implemented through OMB guidelines.<sup>74</sup>

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<sup>71</sup> U. S. Office of Management and Budget. OMB Circular A-123, Internal Controls, rev. August 4, 1986, p. I-4.

<sup>72</sup> Ibid., Appendix B.

<sup>73</sup> U. S. Office of Management and Budget. OMB Circular A-127, Financial Management Systems, December 19, 1984, para. 2.

<sup>74</sup> The 4th and latest report of the GAO on the implementation of the FMFIA indicates that most of the problems are known, have been known for years, yet remain uncorrected after almost 7 years (p.5.). GAO identifies a need for "changes in the management philosophies and the general environment under which federal programs operate," (p.52) and recommends Congress hold annual hearings through the appropriation, authorization, and oversight committees to ensure completion of the corrective actions required to comply with the act (p.53.). U. S. General Accounting Office. Inadequate Controls Result in Ineffective Federal Programs and Billions in Losses, Financial Integrity Act, Report to Congress, GAO/AFMD-90-10, November 1989.

OMB Circular A-127 provides that each agency shall have a "single, integrated financial management system, which may be supplemented by subsidiary systems. Data...shall be entered only once and transferred automatically to appropriate accounts or other parts of the system or systems."<sup>75</sup> The Circular further states that the accounting system should meet the objectives of usefulness, timeliness, reliability and completeness, comparability and consistency, and efficiency and economy. In describing the usefulness of the data, OMB states:

...financial management data shall be gathered and processed only where necessary to meet specific internal management needs or external requirements. Reports shall be tailored to specific user needs and if report usage does not justify cost, reports shall be terminated.<sup>76</sup> [author's emphasis]

OMB states that in the area of reliability and completeness, data shall be verifiable and "ordinarily"<sup>77</sup> drawn from the official records and systems. In the area of comparability and consistency, OMB requires that "accounting shall be synchronized with budgeting."<sup>78</sup>

In describing data support to managers, OMB states that accrual accounting information "shall be developed only as needed for pricing purposes, comparative cost analyses, and to meet the needs of management or the Congress."<sup>79</sup> [author's emphasis] Finally, regarding the full financial disclosure provision of the Budget and Accounting Procedures Act of 1950, OMB states that:

Financial disclosure requirements are met through the Budget, the Treasury Combined Statement, and related documents. Agencies contribute to this disclosure through required reports to OMB, Treasury, and the Congress and through proper recording and classifying of financial data. Any other financial statements intended for use by the public shall be submitted to

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<sup>75</sup> U. S. Office of Management and Budget. OMB Circular A-127. Financial Management Systems, December 19, 1984, para. 3.

<sup>76</sup> Ibid., para. 6.a. [The OMB focus on producing specific reports is one of cost/benefit.]

<sup>77</sup> Ibid., para. 6.a. [Allows "flexibility" in providing data from other than official records and systems.]

<sup>78</sup> Ibid., para. 6.a.

<sup>79</sup> Ibid., para. 6.d. [Focus on accrual accounting is for external purposes, not on its use for internal management.]

OMB for review and approval, and shall be evaluated on the basis of costs and benefits and for consistency with the Budget.<sup>80</sup> [author's emphasis]

## CURRENT FEDERAL ACCOUNTING AND BUDGETING PRACTICES

### Federal Accounting Background

As detailed in the previous section, there are numerous laws and regulations governing how federal accounting is conducted. In addition, the responsibility for the guidance is fragmented between GAO, OMB, the Treasury, and Congressional actions during the appropriation process. Further, agencies have the prerogative to adapt their individual systems to their own agency management needs, provided they stay within the general guidelines. Therefore, there is no standardized, integrated, federal government accounting structure or system. As stated by Cornelius Tierney in his book on federal accounting practices:

Several basic considerations are being examined by the GAO and others interested in improving and enhancing the accounting of government. However, without a modification of the conditions to which systems must respond, government accountants and managers find themselves in a position of accounting for conditions set forth in law and externally mandated reporting requirements and, only secondarily, addressing the financial information that might be required to monitor the activities and operations of government programs.<sup>81</sup> [author's emphasis]

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<sup>80</sup> Ibid., para. 6.e. [Clear indication that the requirement for financial disclosure is met through the "prototype" Treasury financial statements. Any other reports must be approved by OMB, and will have a budget focus.]

<sup>81</sup> Tierney, Cornelius E. Handbook of Federal Accounting Practices, Reading, MA: Addison-Wesley Publishing Co., 1982, p.6. [The need for federal agencies to respond to the external "banker", the Congress, overshadows any other considerations. In other words, if the Congress is not interested in, and holding agencies responsible for operating data, agencies will either not produce such data, or will not use such data if it is produced.]

## Appropriations, not Agencies, are the Accounting Entities<sup>82</sup>

The appropriation is the accounting entity, not the agency. The basis for departments and agencies to collect taxes and other revenues, and to incur obligations and make expenditures from the treasury, is the appropriation of funds or the budget authority approved by Congress. Because the accounting entity is the appropriation, the agency must record all assets, liabilities, and government investment by the individual appropriation. In other words, although agencies are required to have an integrated accounting system, they must provide detailed accounting records for each appropriation.<sup>83</sup>

## Fund or Appropriation (Cash) Accounting

The term fund<sup>84</sup> is synonymous with appropriation, and the accounting for funds or appropriations is rooted in the Constitutional requirement that money will only be drawn from the treasury in the form of an appropriation. In addition, laws exist that provide sanctions against individuals who overobligate or overexpend funds, or spend funds for other than their intended purpose. Further, since Congressional oversight is centered on appropriations or funds, and agencies must request authority to spend by appropriation or fund, the President's budget is structured on a fund and appropriation basis, with programs addressed within the various funds or appropriations.

The importance of fund accounting to the federal financial manager is emphasized by Tierney as follows:

To the individual financial manager, "fund accounting" is almost immediately equated to "appropriation accounting." It is the integrity of the appropriation that must be controlled, monitored, and reported upon. Agency program managers, while not adverse to receiving information on the accrual basis of accounting, have

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<sup>82</sup> This is not intended to overlook the fact that the agency is also an operating entity, whose head is charged with performing the mission or delivering the service as per the agency charter, laws, regulations, etc.

<sup>83</sup> Tierney, Cornelius E. Handbook of Federal Accounting Practices, Reading, MA: Addison-Wesley Publishing Co., 1982, p. 7.

<sup>84</sup> Although, in practice, the actual distribution of the fund or appropriation throughout the agency in the form of an allotment also constitutes a fund, this paper concentrates on the agency level, in which case fund is synonymous with appropriation.

difficulty using such information to resolve questions concerned with obligations and expenditures, items of prime significance to the Congress, OMB, and the Treasury.[author's emphasis]<sup>85</sup> Also, the initial indication of any program progress will be revealed through the rate and trends of obligations and expenditures.<sup>86</sup>

The Department of the Treasury, Financial Management Service, conducts a training course for federal managers that addresses improving program results through sound financial management practices. The workbook for the training program stresses the use of financial management techniques for program planning, monitoring, and forecasting. Techniques include cost/benefit analysis and output measures to plan and budget, with program monitoring and results forecasting focusing almost exclusively on cash-basis accounting measures, e.g. prior year's experience, current plans and budgets, expenditure flow analysis and obligations to outlay conversion period.<sup>87</sup> There is no mention of accrual accounting techniques and analysis.

Within the structure of fund accounting, the DOD has a policy of full funding for procurement programs, e.g., funding for weapon systems. The DOD policy is reflected in the DOD Budget Guidance Manual as follows:

It is the policy of the Department of Defense to fund fully procurements that are covered within the procurement title of the annual DOD Appropriation Act...The objective is to provide funds at the outset for the total estimated cost of a given item so that the Congress and the public can be fully aware of the

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<sup>85</sup> In addition, they may not even be aware that such information exists, or if they do know it exists, may not understand how to use it. See: Euske, K. J., and P. W. Blondin. "Accrual Accounting in a Federal Agency." Government Accountants Journal, Fall 1985, p. 44.

<sup>86</sup> Tierney, Cornelius E. Handbook of Federal Accounting Practices, Reading, MA: Addison-Wesley Publishing Co., 1982, p. 104.

<sup>87</sup> U. S. Department of the Treasury, Financial Management Service. What's All This Jazz About -- Guidebook, September 1989, pp. 53-54.

dimensions and cost when it is first presented in the budget.<sup>88</sup>

In this manner, the total cost of a procurement is reflected in its first year of procurement.

#### Budgetary and Obligation Accounting

All federal agencies must be included in the President's budget. The appropriations for a particular year set the limit on the amount that may be obligated by federal agencies; that is, the amount that may be spent on goods and services in current or future years. The amount budgeted and funded for any agency is stated in terms of budgetary authority to obligate by appropriation. The budgetary authority by Congress provides the basis for agencies of the federal government to incur obligations and make expenditures from the Treasury. Thus the tracking of obligations and resultant expenditures necessarily becomes the federal manager's primary concern.

Budgetary accounting tracks the obligation and expenditure of funds through the various administrative and legal subdivisions of authority to obligate back to the appropriation. It is the bookkeeping aspect of the fund accounting process,<sup>89</sup> and provides the activity and sub-activity check on compliance with budget authority limitations.

#### Accrual Accounting

As indicated earlier, legally, in addition to fund accounting, the federal government is also required to account on an accrual basis. Many federal agencies, however, do not have accrual accounting systems. As indicated by Tierney, often alternative methods are used to derive the information necessary to feed accrual information from cash-based accounting systems to the agencies requiring such information for external reports and financial statements. He further points out that these agencies generally do not make a distinction between accrued expenditures, the receipt or acceptance of goods or services, versus accrued expense or cost, the consumption or use of goods or services.<sup>90 91</sup>

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<sup>88</sup> U. S. Department of Defense. Office of the Comptroller of the Department of Defense. DOD Budget Guidance Manual, May 1990, p. 241-12.

<sup>89</sup> Tierney, Cornelius E. Handbook of Federal Accounting Practices, Reading, MA: Addison-Wesley Publishing Co., 1982, p. 105.

<sup>90</sup> Ibid., p. 110.

(continued...)

## Federal Reporting

Federal agencies must prepare financial reports that are of three varieties: budgetary reports, cash reports, and financial statements. For the federal manager, the reports of primary significance [as the federal managers is held personally accountable for the data in these reports] are the budgetary reports. These reports are required by OMB and the Treasury Department, and report the agency financial status by appropriation on budget authority, obligations, collections, and disbursements. The reports of next highest significance are the cash reports [again, important to the federal manager because of personal accountability] required by the Treasury. These reports are again by appropriation and report positions on cash, receipts, reimbursements, and disbursements. The third and least significant reports for federal financial managers are the financial statements.<sup>92</sup> Unlike the previous two types of reports, these are not based on appropriation, but are general purpose reports required by the Treasury Department for use by external parties. They are based on accrual data, by organization showing assets, liabilities, and equities.<sup>93</sup>

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91 The distinction being that in federal agency "accrual" accounting, the goods and services are assumed to be consumed as they are received, rather than when they are actually used. This, of course, is not what is meant in the private sector by accrual accounting, where accrued cost or expense occurs upon the use of goods or services, not simply upon their receipt.

92 An article by Euske and Blondin on the Navy accrual accounting system bears out this observation. Federal managers [aside from those who must prepare such statements] are often not even aware that such information and reports exist. Euske, K. J. and P. W. Blondin. "Accrual Accounting in a Federal Agency." Government Accountants Journal, Fall 1985, p. 44.

93 These financial statements are produced as the Standard Form (SF)-220, Statement of Financial Position; the SF-221, Report on Operations; the SF-222, Report of Cash Balances; and the SF-223, Reconciliation Report. The 1989 version of OMB Circular A-11 required "business-type budget statements...shown on a accrual basis," (p. 120) while the 1990 version calls for the submission of "business-type statements...based on accrual accounting concepts." (p. 120) [The author is not certain what the shift in emphasis accomplishes.] In both cases, the Circular indicates that the entries must correspond to those of the SF-220.

## WHAT IS GAAP?

### GAAP FEATURES

Generally accepted accounting principles (GAAP) are a set of agreed upon principles and components of basic financial statements which are designed to report an operating entity's financial status to those external to the entity. According to Charles T. Horngren, because "accounting is more of an art than a science,"<sup>94</sup> there exists GAAP. Horngren goes on to describe GAAP as a "huge bundle of assumptions and conventions" that become "generally accepted" by agreement.<sup>95</sup> He warns that it might be better to call the GAAP conventions, because the word "principles" connotes a product of airtight logic.<sup>96 97</sup>

GAAP defines the components of basic financial statements as the balance sheet, the statement of operations, the statement of changes in cash flow, the statement of changes in stockholders' equity, the description of accounting policies, and the notes to the financial statements.<sup>98</sup> General purpose financial statements are designed to meet the need of many users, often unidentified at the time of statement preparation. For this reason, it is important to sufficiently standardize the form, content and methods of statement preparation so that the external users can analyze entities using a common format. The financial statements are produced to meet the objectives of the external users in using the financial statement to evaluate a business enterprise's ability to generate a favorable cash flow, and to judge the entity's worth as a source of goods and services.<sup>99</sup> For the state and local governments, financial statements provide external users with information concerning "the solvency of the

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<sup>94</sup> Horngren, Charles T. Introduction to Financial Accounting, Englewood Cliffs, N. J.: Prentice-Hall, 1981, p. 61.

<sup>95</sup> Ibid., p. 61.

<sup>96</sup> Ibid., p. 61.

<sup>97</sup> Others have suggested the use of "standards", "postulates", and even "assumptions" or "premises". Einhorn, Raymond, American University, to author.

<sup>98</sup> Seidler, Lee J., PhD, CPA, and D. R. Carmichael, PhD, CPA, ed. Accountants' Handbook, 6th ed., New York: John Wiley & Sons, 1981, p. 4-3.

<sup>99</sup> Ibid., p. 6-3.



government and its ability to service its debt on a timely basis."<sup>100</sup>

The Accountants' Handbook speaks of the limitations of financial statements as follows:

- They are historical [rather than being based on market or other values]\*
- They are stated in terms of a fluctuating [monetary]\* unit of value
- As interim reports, they [necessarily]\* contain many estimates and judgments
- They are expressed for a "going concern"
- Because they are GAAP-based, they permit "both a considerable lack of uniformity among firms and restrict matters portrayed to a set of agreed-on conventions."<sup>101</sup>

\* author's inserts for clarity

#### HISTORY OF GAAP

The history of GAAP has its earliest roots in the history of the accounting profession as charted in the Accountants' Handbook.<sup>102</sup> Significant events are summarized in the following paragraphs.

Instead of being established within a conceptual framework, the early development of accounting principles was done in a piecemeal fashion with alternatives being created to handle unusual situations. As the need for accounting education was realized, the predecessor to the American Institute of Certified Public Accountants (AICPA), the American Association of Public Accountants, was created. In December 1896, the first Certified Public Accountant (CPA) exam was given.

Early in the 20th century, the Federal Trade Commission (FTC) was dissatisfied with the audited financial statements for

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<sup>100</sup> Holder, William W. A Study of Selected Concepts for Government Financial Accounting and Reporting. National Council on Governmental Accounting, Research Report, Chicago, Illinois, 1980, p. 22.

<sup>101</sup> Ibid., p. 4-6.

<sup>102</sup> Ibid., Chapter 3.

businesses. The FTC wanted more of a focus on uniform systems of accounts. The Federal Reserve Board, on the other hand, wanted more of a focus on improving auditing standards, and in 1917 issued the Federal Reserve Bulletin of 1917 designed to improve auditing standards and procedures.<sup>103</sup>

Amid growing dissatisfaction with the financial reporting of business entities, in 1927, the accounting profession began to work with the New York Stock Exchange (NYSE) to improve the financial reporting of companies listed with the NYSE.<sup>104</sup> In 1929, when the stock market crashed and the Great Depression followed, it was evident that loose accounting and reporting practices contributed to the situation. At that point, what had started as an informal coordination between the accounting profession and the NYSE became an official collaboration, and in 1933, the NYSE stated that companies that it listed had to have a "certificate" from independent public accountants.

In 1933, the Securities Act was enacted to tighten up loose accounting and financial reporting practices and to provide legal protection for investors. Shortly thereafter, the Securities and Exchange Commission (SEC) was created with the Securities Exchange Act of 1934. The SEC was responsible for ensuring adequacy of financial reporting, and could prescribe accounting rules, and require a "certification" of annual reports by an independent auditor. The SEC has been known as a "prodger of the [accounting] profession"<sup>105</sup> since its inception.

In 1938, the AICPA created the Committee on Accounting Procedures and issued its first Accounting Research Bulletins (ARBs). These ARBs narrowed the differences in treating accounting situations, and indicated preferences to reduce alternative treatments. By 1953, the Commission had issued 42 ARBs which were reviewed and revised, and reissued under ARB 43 along with definitions of accounting terminology. During this period, the SEC continued to be the force for ensuring compliance with preferred practices.

In 1959, the ARB Committee was taken over by the Accounting Principles Board (APB). The APB was to establish accounting principles and standards to ensure greater comparability in financial reporting. The Board, however, expended limited effort in developing a conceptual framework of accounting, and ceased operations in June 1973.

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103 Ibid., p. 3-5.

104 Ibid., p. 3-5.

105 Ibid., p. 3-6.

In November 1973, the Financial Accounting Standards Board (FASB) assumed responsibility for developing the conceptual framework of accounting principles and standards for financial reporting. Its process for standard setting and objectives are grounded in the reports of two AICPA committees which studied the issue of standardization of financial reporting. The Wheat Committee Report of March 1972 provided recommendations on improving the standard setting process that are closely followed today. The Trueblood Committee Report of October 1973 identified fundamental objectives of financial statements.

FASB exists to define GAAP for the private sector accounting profession. When considering an accounting issue or project, FASB must follow a "Due-Process"<sup>106</sup> procedure before deciding on and issuing any guidance to the private sector accounting professions. For each issue considered, this process requires:

- Appointing a task force to consider the issue
- Doing a literature study and research
- Issuing a discussion memorandum
- Providing a public hearing on the issue
- Issuing an exposure draft for comment
- Considering comments and evidence on the issue

As a parallel to the FASB for the setting of private sector principles and standards of financial reporting, the Governmental Accounting Standards Board (GASB) was established in 1984 to establish financial accounting and reporting standards for state and local governments. The GASB also follows a due process that is essentially the same as FASB's before issuing its standards and pronouncements.<sup>107 108</sup>

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<sup>106</sup> Ibid., p. 3-16.

<sup>107</sup> Governmental Accounting Standards Board. Facts About GASB, Norwalk, CT, 1990, p. 1.

<sup>108</sup> Under its financial management improvement initiatives, the GAO has proposed formation of a board to follow due process for formulation of proposed federal standards and principles. This is an important step both as a fact-finding procedure, and to ensure acceptance of all pronouncements.

## CATEGORIES OF ACCOUNTING

### Financial Accounting

The purpose of financial accounting is to provide a report to external decision-makers on the historical, custodial, and stewardship aspects of accounting.<sup>109</sup> It is GAAP-based, and provides a structured approach to presentation that consists of an income statement, a balance sheet, and a statement of cash flow. It also depends on the independent audit for confirmation.

Financial accounting has its foundations in accrual accounting and depends on the measurement or valuation conventions of realization, matching, and a [presumed] stable dollar.<sup>110</sup> Revenues are realized when goods or services are sold or delivered. In matching, revenues and expenses are related to each other for particular transactions in a particular period. Matching may not be readily identifiable, transaction by transaction. The significance of the stable dollar as the unit of measurement assumes that the dollar is "an unchanging yardstick"<sup>111</sup> which provides a uniform measure of assets and equities.

### Cost Accounting

In many ways, cost accounting shares many of the same purposes of financial accounting. It is also relatively synonymous with managerial accounting as it services many purposes.<sup>112</sup> Cost accounting used to refer to the accumulation and assignation of historical cost information in order to determine cost of goods or services sold, or otherwise used up (as in construction); inventory valuation; and income. Today, however, cost accounting also describes the process of accumulating costs for use by management to make decisions on recurring operations and strategic plans and policies. It is also instrumental in providing information to external parties.

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<sup>109</sup> Horngren, Charles T. Cost Accounting: A Managerial Emphasis, 5th ed., Englewood Cliffs, N. J.: Prentice-Hall, 1982, p. 4.

<sup>110</sup> Horngren, Charles T. Introduction to Financial Accounting, Englewood Cliffs, N. J.: Prentice-Hall, 1981. pp. 62-64.

<sup>111</sup> Ibid., pp. 63.

<sup>112</sup> Horngren, Charles T. Cost Accounting: A Managerial Emphasis, 5th ed., Englewood Cliffs, N. J.: Prentice-Hall, 1982, p. 4.

## Management Accounting

Management accounting refers to the internal accounting systems which provide managers with the information necessary to plan and control. It is the process of "identification, measurement, accumulation, analysis, preparation, interpretation, and communication of information that assists executives in fulfilling organization objectives."<sup>113</sup> In supplying information to management, Horngren points out that the accountant helps to answer three basic questions:

1. Scorecard questions: Am I doing well or badly?
2. Attention-directing questions: Which problems should I look into?
3. Problem-solving questions: Of the several ways of doing the job, which is the best?<sup>114</sup>

Horngren points out that both the scorecard and attention-directing questions rely on similar data, in that typical performance reports highlight actual results with planned or budgeted standards. The type of analysis to answer these first two questions relies on accumulation of data and the analysis of routine recurring internal reports. The aspect of accounting needed to answer the third question related to long-range planning and special decisions, however, generally relies on special analyses or reports from experts such as industrial engineers, budgetary accountants, and statisticians.<sup>115</sup> These three questions involve often overlapping issues and the distinction among them is not as important as realizing that the accounting system to accumulate the data to answer the questions is simply a means, while the better decisions are the ends.<sup>116</sup> [author's emphasis]

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<sup>113</sup> Horngren, Charles T., and Gary L. Sundem. Introduction to Management Accounting, Englewood Cliffs, N. J.: Prentice-Hall, 1987, p. 4.

<sup>114</sup> Ibid., p. 4.

<sup>115</sup> Ibid., pp. 4-5.

<sup>116</sup> Ibid., p. 5. [The choice of accounting systems and data, therefore, should seem to rest on the cost and benefits of such systems and their ultimate ability to improve the decision-making process.]

## GAO APPROACH TO FEDERAL FINANCIAL MANAGEMENT REFORMS

### Strengthened Accounting, Auditing, and Reporting

The GAO describes the approach toward better accounting, auditing and reporting as being dependent on a well-designed integrated budgeting and accounting system. Such a system should display costs and revenues by several dimensions, e.g. appropriation, organization, program, project. In addition, recording and reporting should be for obligation, payment, and the use<sup>117</sup> of goods and services (costs or expenses). Further, performance information should be provided to make judgments as to efficiency and effectiveness. The systems to accomplish this end would reflect "differences in fact, rather than differences in the accounting treatment of the same facts."<sup>118</sup>

### Improved Planning and Programming

This improvement would concentrate on a structured financial management system that would focus on major policy issues as well as their consequences. The system would provide actual costs and benefits of prior decisions and would use a formal, analytic process that would be integrated into the financial system. GAO states that "To be successful, a planning and programming structure must be an integral part of financial management decisionmaking, as it is in the Defense Department."<sup>119</sup> GAO further states that the system must be designed to meet the individual needs of each agency and program area.

### Streamlined Budget Process

GAO would improve the federal budget process by attempting to reduce the layers in the congressional budget process or reduce the number of Congressional budget decisions which must be

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<sup>117</sup> [Presently, the receipt, not the use of goods or services, is the transaction recorded in the federal government.] Professor Einhorn, of American University, indicates that both should be recorded.  
Einhorn, Raymond. American University, to author, July 1990.

<sup>118</sup> U. S. General Accounting Office. Managing the Cost of Government: Building an Effective Financial Management Structure, Major Issues. Vol. I, February 1985, GAO/AFMD-85-35, p. 14.

<sup>119</sup> Ibid., p. 16.

made annually. GAO states that:

Budget execution, like budget preparation, has grown more detailed and complex. Managerial flexibility and efficiency is increasingly limited by the growing number of constraints on the uses of funds imposed by both Congress and executive branch officials.<sup>120</sup>

#### Systematic Performance Measurement

In this approach to financial system improvement, GAO would require that employee and program performance be assessed and measured. GAO acknowledges that even the best performance measurement system cannot answer important questions regarding program effects and policy alternatives.<sup>121</sup> However, these questions can be addressed by special reports that would supplement the regular performance reports.

#### GAO's Means to Reform

The instruments necessary to put in place the GAO proposed reforms are:

- Systems development - using the latest technology, implemented over a period of years at the minimum cost.
- Organizational changes - implemented to obtain efficiency and effectiveness by consolidations using modern technology to streamline policy making.
- Investment in people - to improve skill levels, improve recruiting, and develop career ladders.
- Political support to maintain the reform process - entailing a firm commitment, clear leadership, and continuity of purpose.<sup>122</sup>

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<sup>120</sup> Ibid., p. 18.

<sup>121</sup> Ibid., p. 21.

<sup>122</sup> Ibid., pp. 22-23.

## QUESTIONS OF RELEVANCE OF GAAP TO THE FEDERAL SECTOR

In doing a literature search and in conducting numerous interviews to determine if and how designing an integrated federal accrual accounting system to produce general purpose financial statements based upon GAAP might benefit the DOD, I came across numerous arguments both for and against various aspects of the issue. Virtually all of the references and most of the personnel interviewed agreed that the federal government, as a whole, needs to have an integrated financial system with standard data elements and structure of accounts, so that summaries and comparisons among different agencies, functions, and time periods could be facilitated.

All of the literature and interviewees agreed that, in order to be of any use, the data had to be reliable, verifiable, and timely [author's emphasis.] From that point of common agreement, however, the views of the experts and practitioners in the field of financial management and accounting, both written and oral, were often divergent.

Perhaps one of the most important points to make is that there appears to be no clear cut agreement on what GAAP, as applied to the federal sector, entails. Is it simply to be a reiteration of what Ronald Young of the GAO<sup>123</sup> says is already the definition of GAAP specifically designed for the federal sector and defined by the GAO's Title 2?<sup>124</sup> Is it envisioned as more closely resembling GAAP as defined by FASB<sup>125</sup> for the

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123 Young, Ronald S., Director, Accounting Principles and Standards Group, Accounting and Financial Management Division, U. S. General Accounting Office, Washington, D. C., interviewed by author, June 27, 1990.

124 U. S. General Accounting Office. Policy and Procedures Manual for Guidance of Federal Agencies: Title 2 -- Accounting, rev. October 31, 1984.

125 It would appear that in its earlier considerations of the nature of a federal entity, the GAO had ruled out equating the federal government with the corporate sector. In attempting to define the government as an "entity", GAO stated "The proprietary, corporate entity, enterprise, and residual equity concepts concentrate on information--such as net income and earnings per share--presumably needed by owners of profit-seeking organizations. The Federal Government, however, manages economic resources which are not used to convert goods and services into profits. Since profit cannot be used to indicate performance, (continued...)"



private sector; or is it to more closely resemble GAAP as defined by GASB for state and local government use? In Congressional hearings on federal management reorganization, the Comptroller General seemed to intimate that the standards he proposes to set would be more in line with those of GASB. He stated that GASB, which was supported in part by Congress, "is a fine board; they are setting standards for the State and local governments, and we plan to use a lot of their material in setting the standards for the Federal Government."<sup>126</sup>

Regarding the current state of GAO Title 2 standards and proposed standards, T. Jack Gary referred to a 1988 draft GAO position paper on federal accounting standards, indicating that the position paper appeared to be prepared by "persons who are heavily oriented in private sector accounting but lack an appreciation of the peculiarities of government finance that dictate accounting and financial reporting principles different in some instances from those in the private sector."<sup>127</sup> Along those same lines, Cornelius E. Tierney, in a recent article on federal accounting, states the following concerning the current GAO standards:

...as currently postulated, the accounting and reporting concepts have failed at the federal level. The present federal accounting and financial reporting practices have not significantly contributed to public sector management. The accounting concepts appear to be more borrowings from the corporate world rather than the result of an effort to analyze the uniqueness of the congressional appropriation process and to design a

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<sup>125</sup>(...continued)

the proprietary enterprise, corporate entity, and residual entity concepts are not relevant concepts for identifying the reporting entity(ies) of the Federal Government." U. S. General Accounting Office. Federal Government Financial Accounting and Reporting Entities, Exposure Draft, October 31, 1981, p. 12.

[This pronouncement, however, appears to run counter to the fact that GAO's Title 2 federal accounting principles and standards are basically modeled after private sector GAAP.]

<sup>126</sup> U. S. Congress. Senate. Federal Management Reorganization, Cost Control, and Loan Accounting Reform. Committee on Governmental Affairs. Hearings, May 13 and 14, 1986. p. 22

<sup>127</sup> Gary, T. Jack, Jr. "An Analysis of the GAO's Discussion Paper on Major Accounting and Financial Reporting Issues of the Federal Government." Government Accountants Journal, Spring 1989, p. 43.

financial system that is responsive to Congress, budget officers, and federal managers as well as taxpayers.<sup>128</sup>

A second important point to make concerns the nature of the arguments on both sides of the issue, but most especially on the part of the proponents for change to GAAP-basis accounting and reporting for the federal sector. In the opinion of this author, and as expressed by some of the literature and some of the interviewees, some of the arguments are primarily conceptual in nature, appear to appeal to what might be described as a "gut level" feeling of what is "undoubtedly" the right approach (e.g., if the government can require business to report using GAAP, the government should adhere to the same requirements; and to do the best for our country we should make this change), are unsubstantiated by hard data, or rely on textbook-type theoretical answers to what are very technically and politically complex issues. In the following section of the paper I present every purported benefit that I came across in the course of my research, as well as the arguments from those opposed to various aspects of the proposed changes. Where a claim was made with no specific backup data or information, it will be presented nonetheless for the reader's benefit, and to enable others to explore further.

#### ARGUMENTS FOR GAAP IN THE FEDERAL SECTOR

##### The Government is no Different from Private Business

Many proponents for GAAP based systems and financial reporting in the public sector feel that the federal government is basically no different than the private sector. The government conducts business; so does the business sector. The federal government insists that the private sector and state and local governments do financial accounting, therefore, why should it not follow its own rules. In the words of Bert Edwards of Arthur Andersen & Co., "We must get away from the concept that "government is different" -- GAAP is necessary to understand results and to plan."<sup>129</sup>

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<sup>128</sup> Tierney, Cornelius E. "Accounting for Government: Sense, Not Nonsense." Government Accountants Journal, Summer 1990, p. 7.

<sup>129</sup> Edwards, Bert. "Current Events in Federal Government Accounting and Auditing: A Practitioner's View." Arthur Andersen & Co. Printed notes from speech presented 16 April 1990, Arlington, Va., p. 4.

## Capitalization and Depreciation of Assets

Many references and persons interviewed argued that, although the federal government depreciates some of its assets, in the area of industrial or commercial-type government enterprises, it should do so for all, or almost all, government assets. The GAO's 1989 annual report indicates that buildings, improvements, furniture, and equipment should all be depreciated.<sup>130</sup> GAO indicates that "the failure of current budgeting practices to recognize the cost of continuing to use an asset also creates serious problems"<sup>131</sup> [although the problems are not specified], and indicates that depreciation charges can serve as a reminder of an asset's limited useful life and the need to repair or replace the asset. GAO further indicates that depreciation should be used as a "asset consumption" amount to be reported as an operating cost, and could be "credited to the capital budget as a means of financing part of the year's costs of acquiring"<sup>132</sup> new physical assets."<sup>133</sup> In a recent article,<sup>134</sup> GAO's Ronald Young references a 1984 joint Auditor General of Canada and GAO study (the Federal Government Reporting Study, or

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<sup>130</sup> U. S. General Accounting Office. "Facing Facts": Comptroller General's 1989 Annual Report, p. 44.

<sup>131</sup> U. S. General Accounting Office. Proposals for Reforming Federal Budgeting Practices, GAO/AFMD-90-1, October 1989, p. 12.

<sup>132</sup> U. S. Department of Defense Inspector General. Charge-Back Accounting Systems for the Cost of Information Technology Resources, Audit Report No. 90-011, November 28, 1989, p. 16, provides support for the idea of using "asset consumption" charges to supplement the re-purchasing of assets by indicating that "managers of data processing activities funded through appropriations recognized the potential benefits of capitalizing assets, of including depreciation expenses in their rates, and of establishing applicable reserves, but only if they could retain the funds they collected to replace their assets in the future...DoD policy prohibited such retention."

<sup>133</sup> U. S. General Accounting Office. Proposals for Reforming Federal Budgeting Practices, GAO/AFMD-90-1, October 1989, p. 15.

<sup>134</sup> Young, Ronald S. "GAO Title 2 Research: What's on the Agenda? Why?" Government Accountants Journal, Winter 1989, p. 26.

FGRS) of user needs regarding financial statements<sup>135</sup>. He indicates that the study showed that "users of federal financial information want information about physical assets that have a market value and that will provide future benefits..."<sup>136</sup>, although he does not indicate in what manner the information will be used.

In Arthur Andersen & Co.'s publication detailing suggested improvements in federal financial management<sup>137</sup>, it is indicated that capitalizing expenditures for long-term assets and spreading the cost of the asset over its useful life using depreciation would facilitate public debate over program costs and require continuing accountability throughout the asset's remaining useful life.<sup>138</sup> The article does not indicate exactly how the use of depreciation will facilitate the debate over program costs. The article further states the worth of depreciation would be to allow measuring of program growth as compared to cash outlays by capitalizing newly procured equipment that will be depreciated over the periods it is in service.<sup>139 140</sup>

#### Strengthened Accounting, Auditing and Reporting

By having an integrated accounting system,<sup>141</sup> data will be more reliable and budget planning based on this reliable data will be more realistic. "Consistent, comparable data from

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<sup>135</sup> U. S. General Accounting Office Joint Study with Auditor General of Canada. Federal Government Reporting Study, Illustrative Annual Financial Report of the Government of the United States, GAO/AFMD-86-30A, 21 March 1986.

<sup>136</sup> Young, Ronald S. "GAO Title 2 Research: What's on the Agenda? Why?" Government Accountants Journal, Winter 1989, p. 26.

<sup>137</sup> Arthur Andersen & Co. Sound Financial Reporting in the U. S. Government: A Prerequisite to Fiscal Responsibility, 1986.

<sup>138</sup> Ibid., p. 7.

<sup>139</sup> Ibid., p. 7.

<sup>140</sup> There is also a case for depreciation vs. leasing. In leasing, there is an annual cash outlay and a cost of operation in contrast to a cash outlay for the total cost of purchase (often solely in the year of purchase).  
Einhorn, Raymond, American University, to author.

<sup>141</sup> In addition, GAO and others stated that the accounting and budgeting systems should be integrated, as well.

integrated financial systems is essential for preparing government-wide financial statements. These statements can supplement other budgeting and accounting information by giving an overall picture of the financial health of the government that is not available elsewhere."<sup>142</sup> In addition, auditing of the financial statements ensures reliability of the data used during the year to produce the financial statements at the end of the year.

#### Improved Programming and Planning

Having the actual costs and benefits resulting from prior decisions that would be provided and facilitated by an accrual accounting system would facilitate more effective planning and programming. A cost-based accrual accounting system would provide a "means to aggregate program costs by major activity area and agency as well as government-wide."<sup>143</sup> GAO points out that it is important to remember that "an effective planning and programming process must of course be designed to meet the particular needs of each agency and program area."<sup>144</sup>

#### BENEFITS OF ACCRUAL ACCOUNTING UNDER GAAP

A GAAP-based financial management system has its foundation in cost-based accrual accounting. As GAO states, "although many agency accounting systems now use some [form of] <sup>145</sup> accrual accounting techniques, only a few of these systems currently record the cost of operations, i.e., the total resources consumed in carrying out a specific operation. Agency budget systems are now obligation-based and pay little, if any, attention to accrual or cost data."<sup>146</sup> Because most federal agencies do not have an

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<sup>142</sup> U. S. General Accounting Office. Managing the Cost of Government: Building an Effective Financial Management Structure, Major Issues, Vol. I., February 1985, GAO/AFMD-85-35, p. 14.

<sup>143</sup> Ibid., p. 16.

<sup>144</sup> Ibid., p. 17

<sup>145</sup> In defense, accrued expenditures indicate goods or services received, which may or may not be used or consumed in the current period. This is in contrast to the term accrued expense or cost, which, as used in the private sector, refers to goods or services used or consumed in the current period.

<sup>146</sup> U. S. General Accounting Office. Managing the Cost of Government: Building an Effective Financial Management Structure, Conceptual Framework, Vol. II, GAO/AFMD-85-35-A, February, 1985, p. 39.

accrual accounting system, the benefits of accrual accounting in the private sector are often given as reasons to employ accrual accounting in the public sector. Proponents of accrual accounting explain the benefits as per the following paragraphs.

#### Costs of Units of Delivered Service and Goods

The CAO states that, although cash basis accounting is necessary in managing fiscal debt, and credit policies, "an accrual basis is essential in measuring and managing the costs of units of delivered service."<sup>147</sup> There is no particular reference to, or demonstration of, how this information will help the federal decision-maker.<sup>148</sup>

#### Provides a Financial Picture of Proposed Operations

An Arthur Andersen & Co. publication concerning the need for change in the federal accounting and budgeting system states that the basis of federal financial management should be an accrual cost accounting system which would be used to produce a cost-based budget. Such a system, it is stated, would "provide management with a financial picture of proposed operations."<sup>149</sup> The publication further states that this system would also provide the full cost of activities, identify the use of all available resources, provide a standard for measuring planned with actual performance, and provide a means for determining unit costs. The system, it is explained, would also disclose unfunded costs and liabilities.<sup>150</sup>

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<sup>147</sup> U. S. General Accounting Office. Managing the Cost of Government: Building An Effective Financial Management Structure, Conceptual Framework, Vol. II, GAO/AFMD-85-35-A, February 1985, p. 17.

<sup>148</sup> Although a case can, in some cases, be made for comparing costs of, for example, different operating units and geographic areas. (Einhorn, Raymond, American University, to the author, July 1990). However, in DOD, as pointed out to the author, there are cases where comparisons cannot be made due to the unique nature of the missions involved. (Nemfakos, Charles P., Associate Head, Office of Budget and Reports, Office of the Comptroller of the Navy, June 7, 1990, interview, the Pentagon, Washington, D. C.).

<sup>149</sup> Bowsher, Charles A., Arthur Schoenhaut, and Rear Admiral Stanley S. Fine (Ret.), The Federal Budget -- Cost-Based in the 1980's, Arthur Andersen & Co., 1980, p. 7.

<sup>150</sup> Ibid., p. 8.

One application of this principle was the Atomic Energy Commission (AEC). The integration of mission and functions of the AEC, however, was heavily dominated by the use of contractors. As stated in the Arthur Andersen article, "adoption and integration of industry accounting and budgeting techniques by the AEC were facilitated by the heavy reliance placed upon contractors to carry out AEC programs."<sup>151</sup> The AEC cost-based budgeting and accrual accounting systems were approved by the Congress, the OMB (for appropriation requests and for operations) and by the GAO in the 1950's.<sup>152</sup>

#### Would Benefit the Congressional Review Process

Proponents point out that for the Congress, instead of looking at incremental costs for particular programs, a cost-based accrual accounting system, as the basis for the budget submission, would provide a look at the total program with each program showing "information on the true cost of programs and the uses being made of all available resources."<sup>153</sup> In addition, under an accrual system, program "stretch-outs" or cancellations would be easily identifiable in terms of costs. Further "each program must be rejustified to the Congress each year at an agreed-upon level of activity since costs and outlays are closely related."<sup>154 155</sup>

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<sup>151</sup> Ibid., p. 9.

<sup>152</sup> Einhorn, Raymond, American University, to the author, July 1990.

<sup>153</sup> Ibid., p. 8. [As indicated in earlier author notes to this paper, statements of benefits without supporting evidence do not serve to reinforce points, i.e., to call something "good" is descriptive, but does not quantitatively (or qualitatively, as the case may be) define the specific attributes that make that something good.]

<sup>154</sup> Ibid., p. 8.

<sup>155</sup> By annually re-competing each and every program, one wonders whether this would help or further hinder the budgetary decision process. As Wildavsky indicates, by focusing on programs, policy implications are difficult to avoid, thus increasing the "in-built tendency to an all-or-nothing, "yes" or "no" response to the policy in dispute." This reluctance to bargain and negotiate could further complicate an already complex and lengthy budget process. Wildavsky, Aaron. The Politics of the Budgetary Process, 4th ed., Boston, MA: Little Brown & Co., 1984, p. 137.

### Improved Accountability of Elected Officials

An Arthur Andersen publication on the importance of financial reporting in the federal government states that cash-basis financial management allows adoption of programs with promises to enact those programs before having knowledge of their full cost.<sup>156</sup> In other words, the focus on cash accounting does not concentrate on the future costs inherent in the up-front commitment by the federal government, so that the current legislator can take credit for enacting a program for which future legislators and taxpayers must bear the undisclosed burden. The publication further states:

This lack of accountability creates an incentive for elected officials to curry favor with today's voters at the expense of tomorrow's taxpayers. This lack of accountability has long been a root cause of fiscal mismanagement within the U. S. Government. In fact, excluding interest expense, nearly all growth in Government spending as a percentage of GNP since World War II is related to programs that involve promises to make future payments.<sup>157</sup>

The article continues to say that by using accrual accounting, accountability of public officials will be enforced as costs will be recognized as they occur.<sup>158</sup>

### More Informed Decision-Making

Because the focus is now on the deficit which is computed on a cash-basis, attention is not focused on an even bigger picture of federal financial standing which would show an even larger GAAP-basis deficit. Accrual accounting systems would show the full impact of financial decisions by providing information on the government's accrued obligations such as pensions and Social Security. In addition, it would show the programs which generate extraordinary cost growth. As the Arthur Andersen & Co. publication on federal financial reporting states, "Citizens should recognize that the accumulated GAAP-basis deficit of the

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<sup>156</sup> Arthur Andersen & Co. Sound Financial Reporting in the U. S. Government: A Prerequisite to Fiscal Responsibility, 1986, p. 7.

<sup>157</sup> Ibid., p. 7.

<sup>158</sup> The DOD, however, has a full funding policy which provides that the full cost of a program is budgeted in its first year of procurement so that the total cost of the program is disclosed up front. The full cost is displayed in the budgetary format, not in an accrual format.



Government represents a claim upon the future standard of living of the American people.<sup>159</sup>

### Avoidance of Crises

Proponents argue that although entities that operate on a cash basis necessarily provide sufficient cash receipts to cover cash disbursements, they tend to defer payments and accelerate receipts in order to enhance the current financial position at the expense of the future cash needs. As in the above point on legislator responsibility, this criticism of cash basis accounting holds that by only being concerned with current payments, there is no disclosure of future costs which may or may not be able to be met. "GAAP-basis, however provides for all costs and recognizes revenues only when earned",<sup>160</sup> thus reducing the chance of an unexpected crisis.

### Provides a Measurement of Performance

Since performance measurement usually relies on comparing costs and benefits, an accrual-based accounting system would provide the cost data necessary to make such a comparison. This is because costs are the only financial measure that is directly related to work performed.<sup>161</sup> Obligations relate to orders placed for the later receipt of goods and services which may or may not be used up immediately. Cash payments may be made before or after goods and services are received and before or after goods and services are used.

### Prevents the Usage of Accounting "Gimmickry"

In the last several years, there have been widely publicized instances of the federal government, in conjunction with the Congress, making accounting "adjustments" that attempt to lessen the amount of the cash-basis measurement of the national deficit.

One such accounting adjustment entailed shifting the final military payday of the fiscal year from the last day of the fiscal year to the first day of the succeeding fiscal year, thus understating the cash outlays for the fiscal year just ending.<sup>162</sup>

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<sup>159</sup> Ibid., p. 8.

<sup>160</sup> Ibid., p. 8.

<sup>161</sup> This is the premise on which the GAO principles and standards of Title 2, from 1950 forward, are based. Einhorn, Raymond. American University, to the author, July 1990.

<sup>162</sup> U. S. General Accounting Office. "Facing Facts": Comptroller General's 1989 Annual Report, p. 8.

Critics of such accounting adjustments call this gimmickry, and relate it to the use of "smoke and mirrors." They argue that such tricks can more easily be accommodated in cash accounting than they can be in accrual accounting (although it is possible to envision in an accrual reporting system, and a cash operating system, reporting correctly on accruals, but, for budgetary purposes, manipulating the outlay by deferring or postponing the payment until the next period.)<sup>163</sup>

Although not an accounting adjustment or trick, there are different ways under a cash-based system of measuring the federal financial position that affect the national economy. One such measurement technique choice is that of measuring the cash position based on either obligations or outlays. The explanation of how this works follows.

Under the full funding concept<sup>164</sup> which states that all costs of a procurement should be funded (obligated) up front, obligations are more likely to occur early in the life of the procurement and in the appropriation. Except for operating appropriations which have a one year life, most procurement appropriations have lives which vary from an average of one to three years. The cash outlay for the multi-year appropriations, therefore, occurs in a more spread-out fashion over the life of the appropriation, ergo, the shift from an emphasis on obligations to an emphasis on outlays. This shift in emphasis was especially important from the Gramm-Rudman-Hollings legislation perspective, as outlay rates have less of a financial impact on the cash position of the federal government than do obligation rates.

#### Promotes Improved Understanding of Financial Transactions

The Arthur Andersen & Co. publication addressing the need for GAAP-basis financial reports for the federal government states that such reports and GAAP-basis budgets would improve the understanding of financial transactions.<sup>165</sup> The report fails to

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<sup>163</sup> Einhorn, Raymond. American University, to the author, July 1990.

<sup>164</sup> U. S. Department of Defense. Office of the Comptroller of the DOD. DOD Budget Guidance Manual, DOD 7110-1-M, rev. May 1990, sec. 241.5, and Congressional Budget Act of 1974, P. L. 93-344, July 12, 1974.

<sup>165</sup> Arthur Andersen & Co., Sound Financial Reporting in the U. S. Government: A Prerequisite to Fiscal Responsibility, 1986, p. 9.

indicate how specifically GAAP-basis reports and budgets will accomplish facilitating this improved understanding.<sup>166</sup>

#### Helps Identify Emerging Issues

The same Arthur Andersen & Co., publication referred to in the previous paragraph states that GAAP-basis reports and budgets "would also help to identify and illuminate emerging issues",<sup>167</sup> but again, without providing any specifics on how such formats will accomplish the claim.

#### Statutorily Required to Perform Accrual Accounting

Of course, the bottom line argument of many proponents is that there has been a statute on the books for forty years that states that the federal government is to have accrual accounting systems and produce cost-based budgets. However, just because a law exists, does not necessarily mean that it is correct (e.g., segregation laws prior to civil rights legislation), nor does it mean that the law will be followed if there is no perceived advantage to or need to follow the law.<sup>168</sup>

Moreover, in many instances, laws are by nature more effective if they prohibit certain practices, and provide for meaningful penalties for violating the prohibition. For example, if a business did not produce auditable financial statements according to the principles for publicly traded companies, the CPA firm would not give the corporation a clean opinion or report; the New York and other Stock Exchanges would not permit the company stock to be listed; the banks and creditors would not extend credit; the Internal Revenue Service (IRS) would frown; the SEC would step in; and the AICPA and other professional organizations would be highly critical. Thus, the penalties cause the generally accepted accounting principles to be acceptable, regardless of how the individual company may feel about those principles.<sup>169</sup> Thus, if one were to institute GAAP in the federal sector, a case could be made for similar sanctions to ensure its implementation.

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<sup>166</sup> To an accountant, this fact may seem obvious. However, the specifics of how this improved understanding is to be facilitated need to be demonstrated in order to alleviate confusion on the issue.

<sup>167</sup> Ibid., p. 9.

<sup>168</sup> Unlike the Antideficiency legislation which provides penalties for overobligation and overexpenditure.

<sup>169</sup> Einhorn, Raymond, American University, to author.

## ARGUMENTS AGAINST GAAP IN THE FEDERAL SECTOR

### The Federal Government is a "Different" Entity

Some common threads run through all accounting and relate to all entities for which financial reporting is needed. At the same time, some organizations are different from those for which generally accepted accounting principles were developed. Not-for-profit organizations fall into this category. In sincere attempts to apply present GAAP to these entities, some well-intentioned people have produced financial statements that boggle the mind and turn readers away uninformed.<sup>170</sup>

Actually, all of the arguments against why certain aspects of changes proposed under the auspices of the GAAP-based financial statements umbrella are inappropriate for the federal government ultimately hinge on one issue. The issue is that the federal government is structured so differently from the private sector, (and arguably, less so from state and local governments) that accounting techniques employed under private sector GAAP are not appropriate to the federal sector. After all, the U. S. Constitution and Congress dictate the appropriation and fund structure.<sup>171</sup> Since the appropriation and fund are among the primary vehicles being monitored, obligations and outlays are among the primary means of Congressional oversight measurement of agency compliance with Congressional controls.<sup>172</sup> Congress also controls the information reporting requirements. In addition, the work of the federal government does not depend on the decisions of a board of directors, company stockholders, and the demands of the financial market; federal performance is mission driven, based on the needs of the nation as dictated by the

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<sup>170</sup> Mautz, R. K. "Why Not-For-Profits Should Report Their Commitments." Journal of Accountancy, June 1990, p. 92.

<sup>171</sup> Chris Hendricks of the DOD IG points out that due to this fund structure, the federal government is essentially a cost center, not a revenue or profit center. Hendricks, Christian, Technical Director for Planning and Policy, Office of the Department of Defense Inspector General; President, Washington Chapter, Institute of Internal Auditors. May 30, 1990, Crystal City, Arlington, VA.

<sup>172</sup> This is not to suggest that program and agency performance, including the ultimate costs to deliver the goods or services, are not also monitored.

executive and legislative branch in response to the demands of the nation's voters. Many of the federal government's programs are social in nature, with no real means to assess program efficiencies, and no real financial "bottom line" on which to assess federal performance.

Martin Ives, Vice Chairman of GASB, in addressing accountability in governmental reporting, states that "financial reporting serves to measure performance. Because governments operate for fundamentally different purposes than business enterprises, it is reasonable to expect that measures to [of] their performance will also be different."<sup>173</sup> He further states that accountability for government financial reporting "must report on service efforts and accomplishments."<sup>174</sup> Ives' sentiments are echoed in a 1986 article in Forbes magazine on whether the federal government should keep its books in the same manner as companies. In that article, OMB spokesman Edwin Dale, when asked whether the federal government should follow GAAP replied, "It's a terrible, arcane idea...the federal government should follow different accounting principles because it is different."<sup>175</sup>

R. K. Mautz states that the differences between private sector and not-for-profit<sup>176</sup> are "monumental".<sup>177</sup> This is because accounting theory, concerned primarily with issues such as income measurement, capital maintenance, and distinctions between liabilities and equity, does not always fit the definition of a not-for-profit entity which transfers resources from contributors out to clients at no cost (as opposed to a business which transfers funds from customers in to equity holders.)<sup>178</sup>

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<sup>173</sup> Ives, Martin. "Accountability and Governmental Financial Reporting." Journal of Accountancy, October 1987, p. 134.

<sup>174</sup> Ibid.

<sup>175</sup> Koselka, Rita. "Uncle Sam's Horror Show." Forbes, April 28, 1986, p. 68.

<sup>176</sup> In his paper on not-for-profits, Mautz indicates that there is really no difference between not-for-profits and government entities, as "the difference between donations and tax payments certainly is important to taxpayers but should have little influence on general purpose financial reporting." Mautz, R. K. "Why Not-For-Profits Should Report Their Commitments." Journal of Accountancy, June 1990, p. 92.

<sup>177</sup> Ibid., p. 93.

<sup>178</sup> Ibid., p. 93.

The importance of recognizing the difference between government and the private sector is again emphasized by Cornelius E. Tierney in a recent article on government accounting:

Attempts to establish federal accounting "principles" and "standards" also suffered because much was borrowed from the corporate sector or adopted from state and local governments. There was minimal recognition that there is nothing like the federal government and possibly none of these accounting conventions were totally appropriate.<sup>179</sup>

#### Assets Not Assets in the Traditional Sense

In trying to assess the nature of federal assets, how does one value such intangible assets as "full faith and credit", the power of taxation, the power to print money, and the achieving of national security objectives? In preparing a federal balance sheet, how would one account for these intangibles, which certainly enter into any equation assessing governmental stability and solvency?

Further focusing on the uniqueness of the federal entity, a former chairman of the GASB, Robert K. Mautz, writes of several issues concerning the categorizing and valuing of government assets for the purpose of developing standards for governmental financial reporting.<sup>180</sup> Mautz questions whether anyone is prepared enough to establish such standards, and when specifically addressing the state and local governmental units states:

My own reflection on the subject leads me to the conviction that appropriate and adequate accounting for state and local governmental units involves a far more complex set of interrelationships, to be reported to a more diverse set of users with a greater variety of interests and needs, than exists in business accounting and reporting...I have the strong feeling that we have not yet asked the right questions about those differences, so we have not obtained the right answers."<sup>181</sup>

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<sup>179</sup> Tierney, Cornelius E. "Accounting for Government: Sense, Not Nonsense." Government Accountants Journal, Summer 1990, p. 4.

<sup>180</sup> Mautz, Robert K. "Financial Reporting: Should Government Emulate Business." Journal of Accountancy, August 1981, pp. 53-60.

<sup>181</sup> Ibid., p. 53.

On the specific nature of asset differences, Mautz writes that many government-owned properties that would be considered assets by the general public would not meet the traditional concept of an asset as contributing, either directly or indirectly, to a positive cash flow, or to a generating of future income for the owner. He gives, as an example, the Lincoln Memorial. If you consider that the Memorial is open to the public, and although generating no revenue, it requires maintenance, repair, and operation, and is therefore generating a cost. In the business sector, an entity that does not generate income, but generates costs would cause a negative cash flow, and would thus be properly categorized as a liability, not an asset. Should such "assets" as the Lincoln Memorial thus be categorized as a liability?<sup>182</sup> In the same category as memorials, Mautz views such entities as public buildings, national and state parks, highways, public schools, universities and colleges that are tax supported, jails, prisons and even local police and fire stations.<sup>183</sup> He indicates that the list should include any entity which requires any tax support.

Mautz's bottom line on the consideration of such concepts as assets and liabilities for the federal government is as follows:

The "building block" definitions of assets, liabilities, equity, revenues, expenses, gains, and losses...fit organizations whose major measures of success relate to net income and return on equity...[t]he implication is that we need to give some serious and perhaps innovative consideration to the nature and accounting for not-for-profit organizations. If they have substantive differences from for-profit enterprises--and I believe they do--we may need some modification of our for-profit building block concepts before we apply them where they do not fit.<sup>184</sup>

In a response to Mautz's pointing out the need to consider the special nature of accounting for not-for-profit organizations, June Pallot, Senior Lecturer in Accounting at Victoria University of Wellington, based upon her work with the New Zealand Society of Accountants (NZSA), proposes some

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<sup>182</sup> Ibid., p. 54.

<sup>183</sup> Mautz, Robert K. "Monuments, Mistakes and Opportunities." Accounting Horizons, June 1988 (editorial), p. 123.

<sup>184</sup> Ibid., p. 123.

revisions of the definition of assets for the public sector.<sup>185</sup> She notes that governmental accounting literature discusses "infrastructure assets"<sup>186</sup> which a 1974 AICPA audit of state and local governmental units "rather crudely"<sup>187</sup> defines as "roads, bridges, curbs and gutters, streets and sidewalks, drainage systems, lighting systems and similar assets that are immovable and of value only to the governmental unit."<sup>188</sup> Pallot argues that having to list such assets in order to discuss them, and to categorize them as immovable and useful to only to the governmental unit, does not seem satisfactory. She asserts that the assets described are clearly of benefit to the entire community. She then indicates that the NZSA has proposed an entire new category of assets for not-for-profit organizations that it terms "community assets".<sup>189</sup>

Community assets would include not only the infrastructure assets listed above, but would include cultural or environmental facilities, as well, and would also include a category that the Canadian Institute of Chartered Accountants refers to as "heritage assets." The NZSA recommends that community assets not be depreciated and reported in financial terms, but be reported in physical terms in a Statement of Resources. Pallot then lists the NZSA's criteria for determining whether an asset should be considered a community asset as:

...the period of use of the asset, the degree to which there is a market in which the asset could be sold, whether or not it is within the capacity of the

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185 Pallot, June. "The Nature of Public Assets: A Response to Mautz." Accounting Horizons, June 1990, pp. 79-85.

186 Van Daniker, Relmond P., and Vernon Kwiatkowski. Infrastructure Assets: An Assessment of the User Needs and Recommendations for Financial Reporting, Research Report, Governmental Accounting Standards Board, October 1986. p. 1.

187 Pallot, June. "The Nature of Public Assets: A Response to Mautz." Accounting Horizons, June 1990, p. 80.

188 American Institute of Certified Public Accountants. Audits of State and Local Governmental Units, New York: AICPA, 1974, p. 17.

189 Pallot, June. "The Nature of Public Assets: A Response to Mautz." Accounting Horizons, June 1990, p. 80.



reporting entity to dispose of the asset, and the purpose for which the asset is used.<sup>190</sup>

Pallot continues in her analysis of assets, and indicates that the idea of assets as a means to an end, i.e., increased cash flows, is difficult to apply to the public sector where most of the benefits received are in the form of services to the community as a whole [author's emphasis.] She indicates that throughout the world, professional accounting organizations are attempting to define non-financial measures of performance for the public sector. She states that, in addition to the traditional general purpose financial statements, the NZSA has a Public Sector Accounting Standard which recommends non-financial performance reporting in a Statement of Objectives, a Statement of Service Performance, and a Statement of Resources.<sup>191</sup>

#### Users of Governmental Financial Information Do Not Use Financial Statements

Proponents on the issue of the federal government producing and disseminating general purpose financial statements, both at the government and agency level, argue that the information produced is needed to provide full disclosure of governmental operations to decision-makers. In addition, they argue that the discipline resulting from preparing such financial statements will ensure that financial management subsystems and subaccounts, e.g., inventory accounts, are in balance.

In an article addressing the AICPA's Discussion Memorandum<sup>192</sup> on federal financial reforms, Robert N. Anthony indicates that the idea of federal financial statements [at the federal government level as opposed to the agency level] is not a new one; that they have, in fact, been published by the Treasury for fourteen years. He remarks, however:

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<sup>190</sup> Ibid., p. 80. Pallot indicates the criteria for community assets comes from the New Zealand Society of Accountants. Statement of Public Accounting Concepts, Wellington: NZSA, July 1987, para. 4.16.

<sup>191</sup> Pallot, June. "The Nature of Public Assets: A Response to Mautz." Accounting Horizons, June 1990, p. 81. The author believes that this point regarding alternative reporting for federal agencies of the qualitative as well as the quantitative, is crucial to evaluating federal effectiveness.

<sup>192</sup> American Association of Certified Public Accountants. Federal Financial Management: Issues and Solutions, Discussion Memorandum, by the Task Force on Improving Federal Financial Management, 1989.

Very few people have seen them or have expressed an interest in seeing them. I know of no executive branch decision or legislation that has been influenced by the information in these financial statements.<sup>193</sup>

Anthony further states that he doubts that the reason they are not used is because they are not audited:<sup>194</sup>

The information presented in these statements is sufficiently accurate for the type of macro decision that might be helped by them. If they don't help decision makers or legislators, they are a waste of effort.<sup>195</sup>

Those that question the applicability of the concepts and principles underlying general purpose financial statements to the federal sector often object on the basis that private sector financial principles and standards were developed after years of study and actual usage within the private sector. The private sector financial statement model was examined by the accounting profession, academicians, and actual users before any standards were adopted. They further argue that such general purpose financial statements were developed to meet the diverse needs of users in evaluating a business entity's ability to maximize profit, shareholders wealth, earnings per share, and return on investment, none of which have specific applicability to the public sector which is not a profit-generating entity.

A key factor to producing financial information is its usefulness. Critics of federal financial statements point out that for fourteen years, the U. S. Treasury has produced "prototype"<sup>196</sup> consolidated financial statements for the U. S.

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<sup>193</sup> Anthony, Robert N. "The AICPA's Proposal for Federal Accounting Reforms." Management Accounting, July 1990, p. 49.

<sup>194</sup> A current development is a consideration that CFO's arrange for audits of the Treasury SF-220's by IG's. Einhorn, Raymond. American University, to the author, July 1990.

<sup>195</sup> Ibid., p. 49.

<sup>196</sup> Jose Placer of the Treasury Department indicates Treasury is working with Price Waterhouse to develop a plan to see what would be necessary to have the description of "prototype" removed from the annual U. S. Government Financial Statements. Placer, Jose, Chief, Financial Reports Section, Financial Management Service, U. S. Department of the Treasury. June 4, 1990, by telephone.

Government that the Secretary of the Treasury in 1976, William E. Simon, described as

a prototype for an annual recurring report on the financial condition of the U. S. Government. It is an attempt to apply the principles of business accounting to the business of government.<sup>197</sup>

On the subject of usefulness of the reported data, R. K. Mautz indicates that most financial statement users are interested in two things -- 1.) is the entity achieving its purpose, and 2.) will it continue to achieve its purpose in the future.<sup>198 199</sup> Because there is no actual bottom line in the federal government on which to judge governmental success like there is in private industry,<sup>200</sup> Mautz suggests:

A simple summary of expenditures by category, receipts by source and a list of expendable assets left over should answer these questions.<sup>201</sup> [the questions associated with the first question]

In regards to answering the second question that financial statement users ask, Mautz makes the point that a not-for-profit should report on "its commitments -- that is, its plans and obligations to provide products and services to clients -- and compare these with its proven ability to obtain contributions [raise taxes].<sup>202</sup> Mautz states that any program which requires funds for any future period is a commitment and should be disclosed in a statement of future obligations.

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<sup>197</sup> U. S. Department of the Treasury, United States Government Consolidated Financial Statements. Prototype Report. Fiscal Year 1975, p. 1.

<sup>198</sup> Mautz, R. K. "Why Not-For-Profits Should Report Their Commitments." Journal of Accountancy, June 1990, p. 94.

<sup>199</sup> Also of concern is whether the purpose has been achieved in the most efficient and effective manner. Einhorn, Raymond. American University, to the author, July 1990.

<sup>200</sup> In fact, Mautz suggests that if one were to see an excess of donations [taxes] over expenditures, rather than being an indication of success [as in the commercial market], it could very well indicate that the entity had not fulfilled its mission. Ibid., p. 94.

<sup>201</sup> Ibid., p. 94.

<sup>202</sup> Ibid., p. 94.

In reflecting governmental financial information<sup>203</sup> in the format of a private business, the fiscal year 1988 total federal governmental prototype financial statement showed the government of the U. S. with a negative net worth of greater than \$2.4 billion. Critics of the usefulness of such information argue that such a report in the private sector would be the basis for a declaration of bankruptcy, when, in fact, the report had no influence on any decision-making process by either the federal sector, the Executive Branch, the Congress, or national or international investors.<sup>204</sup> In addition, the fact that basically, the prototype financial statements are prepared on a cash basis, and as Arthur Andersen & Co. indicates when reviewing the data from the initial Treasury prototype statement:

There are a number of uncertainties associated with these consolidated financial statements:

Omitted Assets - Certain strategic military inventories have been omitted because relevant information is classified. The value of the outer continental shelf and related mineral rights, and certain land originally owned by the Government, has been omitted pending further study on appropriate valuation of these assets.<sup>205</sup>

The Arthur Andersen publication further indicates that assets are undervalued (gold valued at less than world prices; certain land, buildings and equipment values estimated and, accordingly possibly understated), and reserves understated for uncollectible loans and receivables, and for certain liabilities for outstanding commitments, guarantees and contingencies.<sup>206</sup>

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<sup>203</sup> U. S. Department of the Treasury, United States Government Consolidated Financial Statements. Prototype Report. Fiscal Year 1988, p. 19, states that the issue of how land and natural resources are valued is still under study; therefore offshore lands are valued at \$1, and land purchase by the government is valued at cost. (In addition, such assets as national stockpiles are not valued because of security reasons.)

<sup>204</sup> The Treasury also produces an annual report for the U. S. government which shows the federal government's cash basis financial position and results of operations. U. S. Department of the Treasury, Financial Management Service. Annual Report, 1989, January 10, 1990., p. 1.

<sup>205</sup> Arthur Andersen & Co. Sound Financial Reporting in the U. S. Government: A Prerequisite to Fiscal Responsibility, 1986, p. 18.

<sup>206</sup> Ibid.

Therefore, critics state that, bottom line, the prototype governmental financial statements do not present a true picture of the financial position of the federal government, and thus are not useful.<sup>207</sup>

Another argument against the usefulness of federal financial statements is that the information is too aggregated to be of any value to decision-makers. The case is made that in the private sector, because the users of financial statements are diverse and generally use them to make comparisons among financial entities, there is a need for a standardized treatment with a "bottom line" provided to creditors, borrowers, lenders, and investors. In addition, in the private sector, there is a need to aggregate information to preclude revealing proprietary operational and management information to competitors. Neither of these reasons applies to the public sector. In fact, there is a need for less aggregated information as Congressional oversight has increasingly become focused more on the micromanagement level.

The issue of the usefulness of aggregated financial statement information is again questioned as critics point to the fact that Congress uses cash management as the means to judge conformance with appropriation and budget vehicles. Additionally, Congress and federal management rely on not just the appropriation and budget data submitted by all federal agencies, but on additional data such as program specific data, and data from the National Income and Product Accounts (NIPA).

In a study<sup>208</sup> of the DON's Resource Management System (RMS) that was set up in response to DOD's Project PRIME<sup>209</sup>, K. J. Euske and P. W. Blondin concluded that, with the exception of not accounting for depreciation, the RMS system was a fairly close fit with GAO's accrual accounting system. They reported, however, that the accrual accounting information that was produced was not used by the DON managers [author's emphasis]:

In the field, RMS activity commanders pay considerable attention to the obligational limitations, as these

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<sup>207</sup> As indicated earlier, the Treasury also produces an annual report for the U. S. government which shows the federal government's cash basis financial position and results of operations.

U. S. Department of the Treasury, Financial Management Service. Annual Report, 1989, January 10, 1990., p. 1.

<sup>208</sup> Euske, K. J., and P. W. Blondin. "Accrual Accounting in a Federal Agency." Government Accountants Journal, Fall 1985.

<sup>209</sup> U. S. Department of Defense. A Primer of Project PRIME. November 1966.

have negative career implications if violated. A detailed review of six major RMS activities failed to reveal any similar concern or even awareness about the accrual accounting expenses by either the comptrollers or the commanding officers [author's emphasis].<sup>210</sup>

The authors go on to state that "there appears to be no awareness of the accrual accounting system within RMS, as indicated by the Activity Staff being hard pressed to discuss differences between such terms as expenses, obligations, and expenditures."<sup>211</sup> The conclusion of the article is stated as follows:

...as monthly field RMS accounting reports are "rolled-up" at the headquarters level, the expense information is selectively stripped off and cast aside. Even Congress, who drafted and passed the Budget and Accounting Procedures Act, fails to solicit or otherwise obtain expense accrual accounting data.<sup>212</sup>

#### Cash-basis Accounting Needed for Internal Control and Congressional Reporting

Whatever the information needs of a given business, the accuracy, completeness, and timeliness of the information derived from an accounting system critically affects management's performance. The accounting information systems should therefore be designed with the needs of management in mind [author's emphasis]. Decisions about which data need to be collected and how it should be organized depend on which factors managers have identified as key indicators of an operations's success.<sup>213</sup>

The government receives monies by funds and appropriations with each agency being essentially an expense account of the government as a whole. In an article on responsibility

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<sup>210</sup> Euske, K. J., and P. W. Blondin. "Accrual Accounting in a Federal Agency." Government Accountants Journal, Fall 1985, p. 44.

<sup>211</sup> Ibid.

<sup>212</sup> Ibid., p. 45.

<sup>213</sup> President's Private Sector Survey on Cost Control: Financial Management in the Federal Government, Report, Management Office Selected Issues, Vol. III, 1983, pp. 42-43.

accounting for governmental units,<sup>214</sup> Cox, Nix, and Wichmann state that "in governmental accounting, most responsibility centers are expenditure centers, measuring the manager's performance by an expenditure budget and by the services provided."<sup>215</sup> The authors go to say that, unlike businesses which spend money to make money, governments first determine expenditures and then budget for revenues with performance indicators being budget outcomes, program variances, and provision of services.<sup>216</sup>

It is argued, therefore, that federal agencies receive monies for expenses, and the only real issue is whether the money received was spent in the manner and amounts as planned (and whether they performed in an economical and efficient manner.<sup>217</sup>) Government agencies therefore use cash accounting to conduct their transactions, as this method captures the flow of funds to and from the budgetary accounts. The issue is merely whether the government has sufficient cash to meet its obligations.

In Budgeting for Modern Government, Donald Axelrod states that in accounting for a government:

It either incurs a cash deficit or achieves a surplus. The revenue that comes in is adequate to meet its needs or the government, short of cash, is forced to borrow funds. It is easy to identify the impact of cash transactions on the money supply and credit markets. In these respects cash accounting tells the whole story, and political leaders and the public understand it.<sup>218</sup>

In his article on government accounting, Tierney states that "[a]ccountants must accept the fact that as a system of planning, resource allocation, macro-management, and fiscal

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<sup>214</sup> Cox, Clifford T., Harold M. Nix, and Henry Wickmann, Jr. "Responsibility Accounting and Operating Control of Governmental Units." Accounting Horizons, June 1989.

<sup>215</sup> Ibid., pp. 38-39.

<sup>216</sup> Ibid., pp. 39-40.

<sup>217</sup> Einhorn, Raymond. American University, to the author, July 1990.

<sup>218</sup> Axelrod, Donald. Budgeting for Modern Government, 2nd ed., New York: Martin's Press, 1988, p. 234.

control the existing system--essentially the cash basis system--works."<sup>219</sup>

Further, in an article on integrating accounting and budgetary systems, James P. Wesberry, Jr. states

It is really unlikely that either legislators or budget officials will accept GAAP-based budgeting. Legislators prefer cash-based budgets because they are accustomed to them and they understand them easily.<sup>220</sup>

Accrual Accounting Not Necessary for the Small Amount of the Budget that is Uncontrolled

A substantial portion of the total federal budget is set each fiscal year due to such items as entitlements (Trust funds, Social Security, etc.) and interest due on the national debt. In addition, "statistically, the experience shows that cash expenditures range between 80% and 85% of the amount appropriated for a given year."<sup>221</sup> Therefore, obligation figures would be the same as expenditure figures for the largest part of the budget. It would appear, therefore, that the cost to institute modifications to the federal financial management systems should be carefully weighed against the benefits to be obtained in alleged controllability of such a small amount of the budget.

A point underscoring the need to keep financial management reforms in perspective is made by Robert N. Anthony in responding to the AICPA Discussion Memorandum<sup>222</sup> on federal financial reforms. Professor Anthony writes:

the staffs of the appropriation committees and the budget examiners in the Office of Management and Budget find the present numbers satisfactory...For the

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<sup>219</sup> Tierney, Cornelius E. "Accounting for Government: Sense, Not Nonsense." Government Accountants Journal, Summer 1990, p. 7.

<sup>220</sup> Wesberry, James P., Jr. "Integrating Accounting and Budgetary Systems." Government Accountants Journal, Spring 1989, p. 17.

<sup>221</sup> Moraglio, Joseph F., and Harry D. Kerrigan. The Federal Budget and Financial System. New York: Quorum Books, p. 28.

<sup>222</sup> American Institute of Certified Public Accountants. Federal Financial Management: Issues and Solutions, Discussion Memorandum, by the Task Force on Improving Federal Financial Management, 1989.



decisions made at their level, expense numbers would be essentially the same as obligation numbers, so the change would not benefit them greatly, and they therefore are not enthusiastic about it.<sup>223</sup>

#### Accrual-based Budgeting May Yield Variances

All budgets are based on estimates. Those based on cash and obligation based accounting systems, especially in DOD, rely in part on estimates based on past performance on a fully funded basis (i.e., the up front costs are reflected in the first year). In formulating an accrual-based budget, however, the estimating would have to be based on, not when the goods or services are to be received, but when they are to be used.

Because of the long-term nature of government programs, it is not possible to report costs in the early years of the program if one is to depend on consumption as the transaction to be measured. As Tierney states, materials are often not used until the latter part of a program, often as late as the third year.<sup>224</sup> Therefore, because the agency generally must prepare its budget approximately 15 months prior to the beginning of a fiscal year, and cost data may not exist until 90 to 120 days after the completion of a fiscal year,<sup>225</sup> agency estimates based on an accrual basis (of consumption as opposed to receipt) might yield considerable variances from eventual actuals.

#### Accrual Accounting Understates the Return on Investment in Early Years

In discussing the reluctance of many managers to accept discounted cash flow analysis models in making capital budgeting decisions, Charles Horngren points out that this reluctance is based on the wide usage of the accrual accounting model for evaluating performance. He states that, even with a high internal rate of return for a project, when using the accrual accounting system, the return is understated in the early years.<sup>226</sup>

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<sup>223</sup> Anthony, Robert N. "The AICPA's Proposal for Federal Accounting Reforms." Management Accounting, July 1990, p. 51.

<sup>224</sup> Tierney, Cornelius E. Handbook of Federal Accounting Practices, Reading, MA: Addison-Wesley Publishing Co., 1982, p. 114.

<sup>225</sup> Ibid., p. 115.

<sup>226</sup> Horngren, Charles T., and Gary L. Sundem. Introduction to Management Accounting, Englewood Cliffs, N. J.: Prentice-Hall, 1987, pp. 360-361.

## Accrual Accounting Not Required to Do Financial Statement

The AICPA's Discussion Memorandum on Federal Financial Management: Issues and Solutions<sup>227</sup> takes the position that sound financial management requires financial reporting with annual audits of the financial statements. The memorandum states that financial statements should consist of a balance sheet, a statement of operations and a statement of cash flows, and discusses the various proposals that have been advanced on how to accomplish this financial reporting. After indicating that the proposals include adopting private sector standards, adopting state and local government standards, and establishing a set of standards specifically for the federal government, it concludes:

Although accounting and reporting standards used by the private sector, and state and local governments contain many essential and sound concepts, it is possible that neither is the best answer for the federal government. Accordingly, the suggestion to adopt uniform guidance tailored to the federal government is, most likely, the appropriate solution.<sup>228</sup>

At no point in the memorandum does the AICPA indicate that accrual accounting is necessary to ensure that financial reporting is performed.<sup>229</sup>

In addition, the Financial Executives Institute (FEI) position paper on federal financial management reforms supports the concept of standardization using uniform accounting standards, and financial reporting, but, as in the case of the AICPA platform, does not mention accrual accounting.<sup>230 231</sup>

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<sup>227</sup> American Institute of Certified Public Accountants. Federal Financial Management: Issues and Solutions, Discussion Memorandum, by the Task Force on Improving Federal Financial Management, 1989.

<sup>228</sup> Ibid., p. 24.

<sup>229</sup> There is a GAO proposal for a federal government accounting standards board (addressed later in this paper) to which the AICPA will defer in deciding the best method of an accounting structure and framework. Einhorn, Raymond. American University, to the author, July 1990.

<sup>230</sup> The previous footnote applies to the FEI, as well.

<sup>231</sup> Financial Executive Institute. FEI Position: Reforming Federal Financial Management Systems, undated.

Tierney addresses the issue of accrual accounting in his article on government accounting. He states:

...accountants, too, must realize that their definition of accrual accounting and costs may be too glib -- not perfect and not responsive to the planning and budgeting issues of the government.<sup>232</sup>

#### Accrual Accounting Not Fully Implemented in States Under GAAP

In arguing that most states give only lip service to the idea of interperiod equity (matching expenses with revenues in the period in which they occur), Robert N. Anthony states:

New York State now prepares financial statements on generally accepted accounting principles basis and publishes them in its annual report. But the budget, enacted by the legislature, is still on a cash basis. Most people will agree that with a cash basis budget that governs spending it is very difficult to get operating managers to pay attention to the expenses as computed on a GASB basis<sup>233</sup> [author's emphasis.]

In a study on the conversion of the Commonwealth of Kentucky to GAAP,<sup>234</sup> the eight year conversion is chronicled only to conclude in the epilogue that although Kentucky's new computerized accounting system uses the GAAP fund structure, accounting during the year is on a cash basis.<sup>235</sup>

The Governmental GAAP Guide for 1988<sup>236</sup> discusses the design of a governmental accounting system as being affected by both GAAP and legal and contractual requirements. It further states:

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232 Tierney, Cornelius E. "Accounting for Government: Sense, Not Nonsense." Government Accountants Journal, Summer 1990, p. 7.

233 Anthony, Robert N. "Observations on Government Financial Accounting Research." Government Accountants Journal, Winter 1989, p. 35.

234 Carpenter, Vivian L., and Ehsan H. Feroz. "The Decision to Adopt GAAP: A Case Study of the Commonwealth of Kentucky." Accounting Horizons, June 1990.

235 Ibid., p. 77.

236 Bailey, Larry P. Governmental GAAP Guide: 1988, San Diego: Harcourt Brace Jovanovich, 1987.

For example, generally accepted accounting principles may require that a transaction be accounted for on an accrual basis but the legal basis may require that the cash method be observed...The problem is usually resolved by maintaining the records on a basis consistent with legal requirements. Supplementary data not integrated with the general ledger must also be maintained in order to convert the legal basis information to a basis consistent with generally accepted accounting principles.<sup>237</sup>

In arguing that budget officials prefer either cash-based or obligation/encumbrance-based budgets because they understand these structures and feel they are more suited to the tasks of budgetary formulation and control, James P. Wesberry, Jr. states:

It is unlikely that they will really even accept that accrual princip[les] [are] inherent in GAAP-based accounting. Recognizing this reality, a number of state and local government[s] are experimenting with what might be called "multiple basis accounting." They are maintaining the basic accounting system on one basis (hopefully GAAP) and periodically adjusting to the other desired basis for budgetary comparison or other purposes so as to provide data on revenues and expenditures in the format needed by the users.<sup>238</sup>

#### Depreciation, in the Traditional Sense, Makes No Sense

Depreciation is recorded in the private sector to spread the costs of an asset over its useful life for the purpose of determining the total costs of operation to be matched with revenues from the sale of goods and services. Depreciable assets are used by a business in the production of goods and services. Depreciation aims to distribute the cost of tangible capital assets (other than land) in a systematic, rational manner over time against earnings. In addition, depreciation is a deductible tax expense. Therefore, the two primary reasons for depreciation, cost determination and tax deductibility, are elements in determining net income and taxable income of a business, respectively. Since the government is concerned with neither from an operating entity standpoint, is depreciation truly relevant to the public sector?

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<sup>237</sup> Ibid., p. 2.24

<sup>238</sup> Wesberry, James. P., Jr. "Integrating Accounting and Budgetary Systems." Government Accountants Journal, Spring 1989, p. 17.

Critics of depreciation in the public sector ask many of the following questions: Is the annual amount of depreciation needed for budget planning? How is the annual amount to be computed, e.g., by equal amounts over time, or by acceleration? Is there a desire to relate depreciation to a "sinking fund" concept to replace assets such as national infrastructure assets?

James M. Fremgen, in writing on whether or not depreciation has a role in governmental accounting states that because depreciation is a sunk cost, is uncontrollable, and therefore is irrelevant to cost control or performance evaluation, the only control that can be exercised is to dispose of old assets or acquire new ones.<sup>239</sup> He writes that the National Council on Governmental Accounting (NCGA) "concluded that the business-like practice of depreciation accounting is appropriate only in a government's business-like activities",<sup>240</sup> e.g. the state and local governments' proprietary funds as opposed to the general funds. He states that depreciation is excluded from the general funds because these funds measure expenditures, not expenses, and to include depreciation would be "to mix an expense, a sunk cost, with those expenses which are current expenditures. Depreciation is neither a source nor a use of governmental fund financial resources."<sup>241</sup> Fremgen goes on to say that depreciation has a minor role in government, but

As in business, depreciation per se is irrelevant in governmental management accounting applications, such as performance evaluation and decision making. Whether depreciation is a useful surrogate for the real cost of using fixed assets is an open question, but there is no body of evidence to support the suggestion that it is.<sup>242</sup>

He concludes by saying that lacking such evidence, perhaps verbal reminders of the importance of capital assets in operations may be preferable to the depreciation expense numbers which may be arbitrary and misleading.<sup>243</sup>

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239 Fremgen, James M. "On the Role of Depreciation in Governmental Accounting." Government Accountants Journal, Winter 1985-1986, p. 11.

(There are other factors not addressed here, for example, the effects of labor-saving machinery.)

Einhorn, Raymond. American University, to the author, July 1990.

240 Ibid.

241 Ibid., p. 12.

242 Ibid., p. 22.

243 Ibid., p. 22.

If depreciation is to be considered for the public sector, not only is the (Mautz) question previously addressed of what constitutes a government asset at issue, but the question arises of what dollar amount shall be used for recording and reporting government assets. Should assets be stated at historical cost, or market value, or replacement cost, or should there be a "standard value" for certain categories of assets?

[The following paragraphs on asset valuation represent a subset of the depreciation issue which the author believe illustrate the complexities of the issues and the nature of the questions regarding government assets which must be decided before any financial management system reforms are undertaken.]

The GAO favors asset valuation at historical cost. However, there has been and continues to be much debate on the relevance of historical cost in periods when inflation exists. Charles Chazen and Kenneth Ira Solomon of Laventhol & Horwath, in an article on the concept of current value accounting, state that sophisticated users of GAAP financial statements seek information not included in the financial statements, knowing that the value of assets are often understated or overstated. In one example in this 1985 article, Chazen and Solomon indicate that in 1981, savings and loan association assets at historical value were \$821.1 billion, but at current value, were \$709.9 billion.<sup>244</sup> [In hindsight, might not the savings and loan crisis become known at an earlier date if the decreasing value of S&L assets were disclosed on their financial statements?]

The idea of historical or book value not always being relevant for economic analysis in today's market is further illustrated by an article by Hobart Rowen, an economist with the Washington Post. In writing to dispel the "hysteria over the growing presence of foreign companies in the United States,"<sup>245</sup> Rowen presents the facts based on information from the Association for International Investment indicating the following:

Based on book value, foreign holdings had topped American direct investment abroad by 1988. But according to a Federal Reserve study based on market value, American ownership abroad at the end of the

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<sup>244</sup> Chazen, Charles, and Kenneth Ira Solomon. "Current Value Accounting -- A Concept Whose Time Has Come." FE: The Magazine for Financial Executives, July 1985, p. 38.

<sup>245</sup> Rowen, Hobart. "Dispelling Some Myths About Foreign Investment." Washington Post, march 18, 1990, H1.

decade was \$785 billion, against foreign ownership here of \$466 billion on the same basis.<sup>246</sup>

As further evidence that the use of historical values as compared to current or market values is being questioned, the Department of Commerce recently announced that it was suspending its estimates of the net international investment position of the U. S. abroad and of foreign assets in the U. S.<sup>247</sup> The Commerce Department, which had previously used a mixture of historic and current valuations, stated

Research suggests that if all components are valued in current prices the level of the net international investment position would be less negative than that computed by the bureau for recent years. Much of the misstatement is due to the direct investment positions, as prepared by the bureau, because they are stated in book values, which reflect prices at the time transactions occurred. Since U. S. direct investment abroad is older on average than foreign direct investment in the United States, it is subject to larger understatement...Work is underway at the bureau to develop investment measures using current-period valuations.<sup>248</sup>

If the issues of how to categorize and state assets could be settled, however, the bottom line argument of critics of depreciation in the federal sector is that decisions on asset purchases or replacement ultimately rest on need, not age or financial usefulness. For example, in the DOD, procuring a major weapon system depends on the assessment of the threat to the nation's security, the DOD's mission, and the state of technology. If the DoN procured an aircraft carrier 10 years ago for \$3 million, and the threat and mission demanded a new aircraft carrier at \$3 billion today, whether or not the original carrier was fully depreciated would have no effect on the decision to purchase a new ship.

#### Would Not Affect the Market

In an study considering whether annual governmental financial reports convey new information directly to the bond

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<sup>246</sup> Ibid.

<sup>247</sup> U. S. Department of Commerce. Bureau of Economic Analysis. "International Investment Position: Component Detail for U. S. Assets and Foreign Assets in the United States for 1989." News Release, July 2, 1990.

<sup>248</sup> Ibid., p. 2.

market,<sup>249</sup> Robert W. Ingram, K.K. Raman, and Earl R. Wilson found that "no significant evidence was obtained to suggest that municipal bond investors use the information in the annual report at the time of its release to adjust bond prices."<sup>250</sup> Ingram, et. al., indicate that because governmental resources are segregated by funds, the measurement focus is not capital maintenance, i.e., revenues minus expenses. "Instead, the major financial objective is generally to break even<sup>251</sup> based on the inflow and outflow of spendable resources. Therefore, it is difficult to construct an unambiguous single measure of expected performance for governments that is comparable to corporate earnings."<sup>252</sup> The authors reference unpublished research from 1987 by V. L. Bernard and T. L. Stober of the University of Michigan indicating that there is "no consistent differences between the market effects of cash flow and current accrual components. In contrast to corporate literature, no evidence exists in the governmental sector regarding market reaction to either "bottom-line" or component measures."<sup>253</sup>

#### Would Not Affect Individual Financial Planning

The joint study between the Auditor General of Canada and the Comptroller General of the U. S., the Federal Government Reporting Study, indicates that individuals do not use general purpose financial statements to make investment decisions.<sup>254</sup> Although individuals expressed a desire to know that their government's operations are efficient and effective, "this need

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<sup>249</sup> Ingram, Robert W., K. K. Raman, and Earl Wilson. "The Information in Governmental Annual Reports: A Contemporaneous Price Reaction Approach." Accounting Review, April 1989, p. 250. [This study was of municipal governmental entities, however, the fact that municipal bonds are traded in the market, yet the financial statements of the municipalities did not affect the market is worth noting. One could surmise that the market relies on other sources of municipal government financial position].

<sup>250</sup> Ibid., p 250.

<sup>251</sup> Professor Einhorn points out that there is thought that the primary purpose is that expenses not exceed revenues. Einhorn, Raymond. American University, to the author, July 1990.

<sup>252</sup> Ibid., p. 251.

<sup>253</sup> Ibid., p. 252.

<sup>254</sup> U. S. General Accounting Office Joint Study with Auditor General of Canada. Federal Government Reporting Study, Summary Report, GAO/AFMD-86-30, 21 March, 1986, p. 10-11.



for information is not clearly related to any specific decisions or activities."<sup>255</sup>

The Federal Balance Sheet Equation Is Not the Same as in the Private Sector

Mautz writes that, in the private sector, two equations portray all of the fundamental accounting relationships. These equations are:

Balance Sheet Equation:

Assets = Liabilities + Owners' Equity;  $A = L + OE$

Income Statement Equation:

Revenue - Expense = Net Income;  $R - E = I$

Regarding the balance sheet equation, Mautz states that the concept of assets is fundamental, that the balance sheet equation represent a "closed system" whereby each element is constrained by all of the others, and unclaimed assets are, by definition, impossible.<sup>256</sup> He goes on to say that to use this same equation for governmental accounting does not work for the following reasons:

- Some government-owned properties do not generate cash flow, but involve costs which generate a negative cash flow, and thus could be considered liabilities.
- Governmental properties are not available to management in the way private sector assets are available, e.g., the government would not have considered selling Central Park when New York City was in financial straights.
- The governmental "fund balance", which is used to account for new assets,<sup>257</sup> is often equated to owners' equity; but taxpayer-citizens do not actually have a claim against this account in that same way that stockholders do of owners' equity in the private sector.

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<sup>255</sup> Ibid., p. 11.

<sup>256</sup> Mautz, Robert K. "Financial Reporting: Should Government Emulate Business." Journal of Accountancy, August 1981, p. 54.

<sup>257</sup> Ibid., p. 55. Mautz suggests that the use of this fund balance to account for new assets is merely a gimmick to preserve the double-entry system, and is an unclear transaction.

- While the liabilities in a private business are essentially self-liquidating because the assets procured produce revenue to liquidate the liability, the same is not true for government where liabilities to procure assets generate future costs to sustain the non-cash-generating assets.<sup>258</sup>

Regarding the income statement equation, Mautz indicates that the private sector net income figure as a measure of success does not exist for the government for the following reasons:

- Matching revenue with expense on the business side of the issue reflects the market reaction to the business, while matching tax and other government revenues with operating expense does not represent such a market test.

- In order to more closely be analogous to a business income statement, the question should be whether the government entity had "paid its own way." In order to determine this, the following calculation would have to be made:

- Add current expenses paid in current period.
- Add current period activities resulting in payments by future taxpayers.
- Add usage of capital assets of current period paid for by previous taxpayers.
- Deduct current year taxpayer payments on prior year taxpayer obligations.
- Deduct current year taxpayer payments on assets benefitting future taxpayers.

Mautz indicates that performing the above calculation: would disclose how much current taxpayers are 1.) paying for current services, 2.) subsidizing future services, and 3.) being subsidized by past services/taxpayers.<sup>259</sup>

#### Liabilities Need Not Be Recorded

Per Mautz, in the business world, the exclusion of liabilities on the balance sheet would be a breach of good faith.

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258 Ibid., p. 55.

259 Ibid., pp. 56-57.

On the government side, however, he states that not recording liabilities on the balance sheet is accepted "possibly because their expected payment will come from resources that also are not reported in the balance sheet."<sup>260</sup>

#### Unit's Effectiveness Not Always Clearly Identifiable

A governmental unit may be effective in what it produces, however, the product it produces may not be a priority item for management or the Congress at a particular point. As such, its efforts, from a purely financial perspective, would have a poor showing. Specifically, attempts to judge effectiveness may not have much meaning when Congress decides to make unilateral cuts, e.g. Gramm-Rudman-Hollings. Figures on efficiency and effectiveness are meaningless given unilateral Congressional financial actions.

In an article on efficiency-based budgeting,<sup>261</sup> William F. Bowlin, Jay R. Wallace, II, and Richard L. Murphy write that the measures of effectiveness are hard to identify because of the difficulty of quantifying inputs and outputs. The authors write that approaches are limited due to "the multiple output nature of governmental organizations and the problems associated with trying to determine a single measure to adequately represent the output of a governmental unit."<sup>262</sup> They indicate that the Air Force attempted to integrate operating efficiency into their budgetary process with a regression analysis program which computed a standard cost per unit. The program, named the Output Measurement Program failed, however, as "the information it provided was neither helpful in identifying problem areas nor in forecasting the impact of mission changes on resource requirements."<sup>263</sup> <sup>264</sup>

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<sup>260</sup> Ibid., p. 54.

[There are different schools of thought on this point. Although such practices as addressed by Mautz may be accepted, there are those who feel they are not necessarily acceptable in that in addition to showing liabilities, the resources to be obtained to cover the liabilities should be shown.]  
Einhorn, Raymond. American University, to the author, July 1990.

<sup>261</sup> Bowlin, William F., Jay R. Wallace, II, and Richard L. Murphy. "Efficiency-Based Budgeting." Journal of Cost Analysis, Fall 1989.

<sup>262</sup> Ibid., p. 35.

<sup>263</sup> Ibid., p. 36.

(continued...)

### Budgetary Decisions are Political and Incremental

If the present budgetary process is rightly or wrongly deemed unsatisfactory, then one must alter in some respect the political system of which the budget is but an expression.<sup>265</sup>

He [Meese] was the world's greatest compartmentalizer. He believed that broad policy would be made in the cabinet and its departments with presidential review and approval. The government's technical "budget and auditing" work, as he called it, would go on in OMB. What he didn't fathom was that policy and the budget are inextricable. He granted me a much greater charter than he realized.<sup>266</sup>

The above quotes are provided as illustrations of the fact that the budgetary process is inherently a very political process. In addition, their presentation is intended to underscore the need for the accounting process to be responsive to, and integrated with, the budgetary process.

Proponents of GAAP-based accounting systems that have an agency and program budget emphasis relate ends to means, rather than the usual line-item considerations of such categories as personnel, supplies, and maintenance. This view often overlooks the reality of the politics inherent in governmental accounting and budgeting. As Aaron Wildavsky states in his book, The Politics of the Budgetary Process, "federal budgeting today is incremental rather than comprehensive, calculated in bits and pieces rather than as a whole, and veils policy implications rather than emphasizing them."<sup>267</sup> He points out that this

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<sup>264</sup> (...continued)

<sup>264</sup> "The development of measures of efficiency and effectiveness is a challenge, regardless of whether budgeting and accounting are on an accrual or on some other basis." Einhorn, Raymond. American University, to the author, July 1990.

<sup>265</sup> Wildavsky, Aaron. The Politics of the Budgetary Process, 4th ed., Boston, MA: Little Brown, & Co., 1984, p. 131.

<sup>266</sup> David Stockman speaking of Edwin Meese's view on economic policy. Stockman, David A. The Triumph of Politics: How the Reagan Revolution Failed, New York: Harper & Row, 1986, p. 83.

<sup>267</sup> Ibid., pp. 135-136.

fragmented approach reduces the area open to dispute, thus reducing conflict. However, when full programs become the focus, it becomes harder to avoid policy implications, and as policy differences become more apparent, conflict is heightened, and there is "an in-built tendency to an all-or-nothing, "yes" or "no" response to the policy in dispute. The very concept of program packages suggests that the policy in dispute is indivisible, that the appropriate response is to be for or against rather than bargaining for a little more or a little less."<sup>268</sup> In other words, rather than bargaining for small increases or decreases, entire programs may be cut based on ideological battles.

John L. Mikesell, in his book on fiscal administration in the public sector, underscores Wildavsky's analysis of the political nature of the budget decision process. He states that in the provision of a public service, there is more involved than simply cost and return on cost. Since there are multiple, mixed objectives which can not be scientifically weighted, "the budget process will be political, involving both pure bargaining or political strategies and scientific analysis."<sup>269</sup> He discusses the process further, highlighting its incremental nature:

The incrementalist view maintains that budgeting is heavily, if not exclusively, a process of political strategy. It rejects the public service delivery orientation of models from public finance economics and rejects budgeting techniques that attempt to make the process more rational. Budgeting, appropriating, and spending is a process of strategies and role playing.<sup>270</sup>

A further statement on the inherent political nature of the budgetary process is quoted in Walter J. Oleszek in his book on Congress and policy. On the issue of budget reform, he quotes one House member as saying, "budget reform is an attempt to correct a problem which is basically caused by policy disagreements, not process weaknesses."<sup>271</sup>

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<sup>268</sup> Ibid., pp. 137-138.

<sup>269</sup> Mikesell, John L. Fiscal Administration, Analysis and Applications for the Public Sector, 2nd ed., Chicago, IL: Dorsey Press, 1986, p. 26.

<sup>270</sup> Ibid., p. 56.

<sup>271</sup> Oleszek, Walter J. Congressional Procedures and the Policy Process, 3rd ed., Washington, D. C.: Congressional Quarterly, Inc., 1989, p. 77.

In examining the relationship between politics and analysis, Quade states that:

Public officials face a dilemma; they may fully understand the advantages of using an analytic approach for allocating resources and otherwise guiding their actions, but at the same time they must face the realities of politics...Decisions thus then to depend more on politics than an analysis.<sup>272</sup>

#### GSA Example

As an example of how the political process affects the ability of federal management to effectively plan, control and report on the management of its resources, the Management Comments section of the General Services Administration (GSA) 1988 Consolidated Financial Statements indicates the following "challenges" not faced by the private sector in managing:

The long and uncertain Federal budget process complicates effective financial planning. Adjustments can occur at a number of stages within the Executive and Legislative Branches, and the dictates of public policy or the Congress often reflect concerns beyond the scope of efficient program delivery for GSA.

Action to provide resources is not always timely. Fiscal year 1988 marked the eighth straight year that GSA did not have an appropriations act at the start of the year. Instead, GSA operated each year under a series of continuing resolutions<sup>273</sup> that extended uncertainty well into the execution cycle.

And, when resources finally become available, there is little flexibility to manage them. Each account, limitation, or program in an appropriations act must be separately administered, and funds generally cannot be moved among them, even when this might be the most efficient response to changing

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<sup>272</sup> Quade, E. S., and Grace M. Carter. Analysis for Public Decisions, 3rd ed., a Rand Corporation Research, North-Holland, N. Y. 1989, p. 373

<sup>273</sup> This factor of continuing resolutions providing funds because appropriations bills are not passed in time for the beginning of a fiscal year adds to the federal government manager's lack of ability/flexibility to manage financial resources. The GAO notes that since the 1960's, continuing resolutions have been used over 90 times. U. S. General Accounting Office. Managing the Cost of Government: Proposals for Reforming Federal Budgeting Practices, GAO/AFMD-90-1, October 1989, p. 25.

circumstances. Even revolving funds do not permit totally unconstrained business operations because customer funding depends on annual appropriation action for the customer agencies.<sup>274</sup>

#### Congressional Oversight Will Not Allow Management Flexibility

Congress has become directly involved in the day-to-day management of Federal operations in order to support local interests, with resulting decreases in administrative efficiency.<sup>275</sup>

Within the DOD, from 1983 until 1989, there existed a plant modernization program for DOD's industrial fund (IF) activities<sup>276</sup>. The Asset Capitalization Program (ACP) was designed to give the IF activities a "greater role in determining specific program requirements."<sup>277</sup> The GAO reported, however, that plant equipment purchases were being restricted because of service- or command-directed projects such as management information systems. In addition, the IF activity management was further restricted in administering the program because of Congressional funding reductions. Congress was not satisfied with the visibility of the program and was considering amending its reporting requirements to provide additional disclosure information.<sup>278</sup> In addition, in 1988, DOD wanted the Navy to convert the funding of IF centers and laboratories from IF to an alternative funding method. GAO, however, advised against this

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<sup>274</sup> U. S. General Services Administration. Financial Statements, Fiscal Year 1988 Results, p. 24.

<sup>275</sup> President's Private Sector Survey on Cost Control: The Cost of Congressional Encroachment, Report, Management Office Selected Issues, Vol. VIII, 1983, p. 2.

<sup>276</sup> DoD established industrial funds (IFs) in 1949. These IFs use working capital funds rather than direct appropriations to finance the cost of goods and services, charging their customers the direct and overhead charges necessary to recover the IF's full paid cost of doing business [e.g., military pay, which has been a "free good", has not been recorded, although the author understands that this issue is currently under review.]

<sup>277</sup> U. S. General Accounting Office. DOD's Management of the Asset Capitalization Program Needs Improvement, Plant Modernization, Report to the Chairman, Subcommittee on Readiness, Sustainability and Support, Committee on Armed Services, Senate, GAO/NSIAD-89-147, August 1989, p. 4.

<sup>278</sup> Ibid., p. 5.

move, indicating that DOD could not support why such a change would be advantageous.<sup>279</sup> However, the fiscal year 1990 Defense Appropriation Bill transferred the ACP to the procurement accounts<sup>280</sup> in order to reduce the individual agency flexibility in determining the best use of its resources.

Given the history of the ACP, critics argue that the management flexibility inherent in an accrual-based accounting system would reduce Congressional oversight, and thus would not be a politically salable idea. David Halwig, a partner at Peat Marwick and Co., was involved with the Navy IF at a time when the DOD wanted the Navy to convert the IF's. Mr. Halwig describes the Navy IF activities as long term programs on a funding cycle that avoided annual review and dollar cuts. Congress has never been comfortable with the lack of appropriated fund control, and it would be doubtful from Mr. Halwig's perspective, that the Congress would be willing to allow the federal government the flexibility of the IF in more of their activities.<sup>281</sup>

The President's Private Sector Survey on Cost Control Panel provides further support to the idea of Congressional micro-management. The panel likens Congressional "interference" in day-to-day agency operations to that of a private corporation's board of directors attempting to run the daily operations of a business.

In our experience, the greater a Board of Directors or a top level management's involvement with day-to-day decisions, the less effective and productive the operating management becomes, especially when over time operating management is thereby prevented from adjusting to the inevitable changes in its environment.<sup>282</sup>

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<sup>279</sup> U. S. General Accounting Office. Decision Needed on Navy's Standard Automated Financial System, Computer Procurement, Report to the Chairman, Subcommittee on Legislation and National Security, Committee on Government Operations, House, GAO/IMTEC-88-47, p. 2.

<sup>280</sup> U. S. Congress. House. Department of Defense Appropriation Act, Fiscal Year 1990, P. L. 101-165.

<sup>281</sup> Halwig, David, Partner, Peat Marwick and Co. May 24, 1990, by telephone.

<sup>282</sup> President's Private Sector Survey on Cost Control: The Cost of Congressional Encroachment, Report, Management Office Selected Issues, Vol. VIII, 1983, p. 2.



The Panel then goes on to state that basic tenets of management which include telling those who execute what to accomplish, not how to accomplish it; giving sufficient tools and authority to perform; allowing management flexibility to employ resources to accomplish mission, and monitoring senior management to ensure they complete the task.<sup>283</sup> These tenets, however, are not followed in the federal government, as the Congress continues to levy more restrictive authorization and appropriation language, and reporting requirements.

On another aspect of Congressional oversight, John W. Gardner describes it as "uneven, unsystematic, sporadic, capricious, meddlesome, opportunistic"<sup>284</sup>. He goes on to say that although not faint and fragile, "it almost never provides a systematic assessment of agency performance against defined standards, and it is unlikely that this will change."<sup>285</sup> In a similar vein, Karen Schuele Walton and Richard E. Brown, in analyzing the possible role conflict between state legislators and auditors, notes that the oversight function is not very popular as it does not help legislators get elected. In addition, in relation to oversight, auditors tend to settle conflict, while legislators tend to avoid it.<sup>286</sup>

Another consideration making it extremely important that legislators be totally supportive of any effort to change the federal financial management structure entails the issue of resources to support any change. The success of any initiative depends upon having sufficient resources to complete the actions necessary to implement the initiative. If the Congress is not completely committed to the change, they will not appropriate sufficient funds to accomplish the mission. For example, a GAO audit report of the Federal Agency Financial Systems Program indicated that the Federal Agency Financial Systems Program has not been able to accomplish its mission which includes development of a government-wide financial plan, because "program officials believe that insufficient resources have hindered their

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283 Ibid., pp. 2-3.

284 Gardner, John W. Comment on paper by Harvey C. Mansfield. "Accountability and Congressional Oversight." Improving the Accountability and Performance of Government, Brookings Dialogues on Public Policy, Brookings Institution, Washington, D. C., 1982, p. 69.

285 Ibid., p. 70.

286 Schuele Walton, Karen, and Richard E. Brown. "State Legislators and State Auditors: Is There An Inherent Role Conflict?" Public Budgeting and Finance, Spring 1990, p. 4.

efforts to adequately accomplish their objectives."<sup>287</sup> Further, in GAO's report on the effectiveness of OMB, GAO indicates that part of the reason OMB was not able to achieve all of the objectives of the Reagan Administration initiatives to improve financial management was because of limited resources. Where GAO judged OMB as effective was where "there was broad agreement among the White House, Congress, and agencies on the need for reform."<sup>288</sup>

On a final note regarding the necessity of the legislative overseers of the budget and accounting process being on board in any change to the current federal financial management system, in order to resolve the potential "budgetary-accounting impasse"<sup>289</sup> Tierney, in his article on government accounting states":

There seem to be two essential elements missing: the will of legislators and the involvement of professionals. For good federal accounting (relevant cost accounting) to exist, there must be the will to do it on the part of Congress.<sup>290</sup>

#### Full Funding Policy in the DOD

The DOD has a policy of full funding in the procurement accounts in order that Congress and the public can see the full impact of budgetary decisions up front. In full funding:

The objective is to provide funds at the outset for the total estimated cost of a given item so that Congress

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<sup>287</sup> U. S. General Accounting Office. Additional Actions Needed to Improve Federal Financial Management Systems, Financial Management Report to the Director of the Office of management and Budget and the Secretary of the Treasury, GAO/AFMD-90-14, April 1990, p. 4.

<sup>288</sup> U. S. General Accounting Office. Revised Approach Could Improve OMB's Effectiveness, Managing the Government, Report to Congress, GAO/GGD-89-65, May 1989, p. 3.

<sup>289</sup> Tierney, Cornelius E. "Accounting for Government: Sense, Not Nonsense." Government Accountant Journal, Summer 1990, p. 9.

<sup>290</sup> Ibid., p. 9.

and the public can be fully aware of the dimensions and cost when it is first presented in the budget.<sup>291</sup>

Full funding causes the initial estimate of an item to be reflected in the Five Year Defense Plan (formerly known as the FYDP, but with the inception of a biennial budget and the resultant six year window, is referred to simply as the Defense Plan).

Because of full funding, the objective of the total transaction cost is displayed up front, which satisfies one of the arguments of the accrual accounting advocates that accrual accounting, as opposed to cash accounting, displays the future cost of a transaction.

#### GAAP-based Accrual Accounting Not Totally Accepted in the Private Sector

Critics say the historical, cost-based financial statement model no longer fully satisfies statement users' varied needs to make business decisions and evaluate managers' performance.<sup>292</sup>

In Budgeting for Modern Government, Donald Axelrod indicates that under accrual accounting, it is as difficult to estimate revenues and expenditures as it is under cash accounting. Because the problem of accruing revenues<sup>293</sup> is even trickier than that of expenditures, the Netherlands dropped accrual accounting. Axelrod indicates that the accrual accounting system surpasses cash-basis accounting for measuring program costs, however, "in practice, accrual accounting rarely covers all costs of programs and projects and concentrates instead on major unfunded liabilities and major resources that are acquired though not necessarily paid for."<sup>294</sup> He states that for a full accounting

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<sup>291</sup> U. S. Department of Defense. Office of the Comptroller of the Department of Defense. DOD Budget Guidance Manual, DOD-7110-1-M, rev. May 1990, p. 241-12.

<sup>292</sup> Pavlock, Ernest J., Frank S. Sato, and James A. Yardley. "Accountability Standards for Corporate Reporting." Journal of Accountancy, May 1990, p. 98.

<sup>293</sup> Axelrod, Donald. Budgeting for Modern Government, 2nd ed., New York: Martin's Press, 1988, p. 240. Axelrod indicates that the U. S. Government accrues corporate taxes, but accounts for personal income taxes on a cash basis because of the difficulty in estimating accrued receipts.

<sup>294</sup> Ibid., p. 241.

of resources, a cost accounting system is the solution. He cautions, however, that cost accounting is expensive because "to capture all the relevant expenditure data, it may be necessary to initiate a multimillion dollar accounting system. Hundreds of thousands, if not millions, of documents must be coded..."<sup>295</sup>

Some recent articles in the accounting journals indicate that GAAP is being questioned as providing the information necessary to accomplish both decision making and stewardship.<sup>296</sup> In an article on the need to improve corporate accountability, Pavlock, Sato, and Yardley point to Comptroller General Charles Bowsher's call for public auditors to adopt some of the standards on performance audits from the federal sector's generally accepted government auditing standards (GAGAS). The results of these audits would then be disclosed to stockholders in addition to financial statements. The authors state that:

Perhaps the time has come for the profession to admit that typical financial statements can't serve all the information needs of interested outside parties.<sup>297</sup>

Another recent article talks about the changes that are taking place in financial reporting.<sup>298</sup> Sever and Boisclair write "Financial reporting is in a transition period -- from an income statement focus to a balance sheet focus."<sup>299</sup> The authors indicate, that for the first time, consideration is being given to recording on the balance sheet, pension liabilities for underfunded plans and postretirement benefits.<sup>300</sup> [Since these are issues which concern proponents of federal financial statements, it would seem that these issues should be investigated as to actual private sector treatment prior to advocating adoption of a private sector financial model.] Sever and Boisclair continue by stating that there may be more changes in financial reporting in the 1990's "if FASB continues to look

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<sup>295</sup> Ibid., p. 241.

<sup>296</sup> Pavlock, Ernest J., Frank S. Sato, and James A. Yardley. "Accountability Standards for Corporate Reporting." Journal of Accountancy, May 1990, p. 96.

<sup>297</sup> Ibid., p. 98.

<sup>298</sup> Sever, Mark V., and Ronald F. Boisclair. "Financial Reporting in the 1990's." Journal of Accountancy, January 1990, p. 36-41.

<sup>299</sup> Ibid., p. 37.

<sup>300</sup> Ibid., p. 38.

at "control" as the common thread that binds the reporting entity." 301

Regarding whether or not accrual accounting is the best way to conduct federal financial management operations, an appendix to the U. S. Government's Fiscal Year 1991 Budget states that "there is, however, no single "right" structure for the Federal budget. The form of the budget is constantly being adjusted to the needs of the President and Congress...the Federal agencies...and the needs of the public...for information with which to judge Federal operations."<sup>302</sup> The appendix goes on to present the budget in the current "unified" concept developed in conformance with the President's Commission on Budget Concepts (1967), the unified budget compared to the GAO's format for operating and capital budgets, and the unified budget compared to the state of California's disaggregated funds budget. The presentation is done to allow those who wish to view alternative treatments to do so.

David Halwig, partner at Peat Marwick and Co., states that accrual accounting would not be appropriate for all aspects of federal government. To make it work effectively for the government, its usage should be focused on certain programs and expenditures, such as those where items have the need to recognize consumption.<sup>303</sup>

#### Potential Costs of a Proposed System of Undemonstrated Benefits

Critics of the GAO approach to instituting GAAP-based financial reporting and full accrual accounting in the federal government state that the conversion of current systems or the institution of a completely new accounting system could be extensive for what has not been demonstrated as beneficial to the decision-making process. Proponents argue that the fuller disclosure that comes from GAAP financial reporting will lead to a more efficient allocation of resources. In his book Financial Reporting: An Accounting Revolution, William H. Beaver states

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301 Ibid., p. 39.

302 U. S. Government. Budget of the United States, Fiscal year 1991, 1990, p. A-11.

303 Halwig, David, Partner, Peat Marwick and Co. May 24, 1990, by telephone.

that "the arguments have not been developed rigorously and rely upon intuition."<sup>304</sup>

As an example, W. E. Daeschner, the Assistant Comptroller of the Navy for Financial Management Systems, in a letter to the DOD Deputy Comptroller, indicated that in implementing the very detailed Standard General Ledger along with the DON Uniform Chart of Accounts, inconsistencies between the two systems were found. In addition, he expressed concern with also having to comply with GAO and the Treasury, and suggested that a full scale analysis of costs and benefits was necessary before going further<sup>305</sup> [author's emphasis.]

As has been speculated, the cost to develop such a system could run into the millions, perhaps billions of dollars. It would seem that the proposed model should be developed and tested, with costs and benefits identified, prior to any decision being made to institute any changes in the federal government accounting system.

#### Congressional Scorekeeping vs. Financial Statements -- Two Sets of Books

As Axelrod writes regarding the reservations on accrual accounting for the federal government:

Unless governments achieve a consensus on accrual accounting, they will bedevil the public with two sets of books--the official statement on the implementation of the budget based on cash outlays, which may give an unduly optimistic picture, and the financial statement based on accrued revenues and expenditures, which may highlight sizeable deficits.<sup>306</sup>

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<sup>304</sup> Beaver, William H. Financial Reporting: An Accounting Revolution, 2nd ed., Englewood Cliffs, N. J.: Prentice-Hall, 1989, p. 162.

<sup>305</sup> Daeschner, W. E. Assistant Comptroller, Financial Management Systems, Department of the Navy. "Implementation of the U. S. Government Standards General Ledger Accounts." Memorandum for the Department of Defense Deputy Comptroller (Management Systems), July 11, 1989, p. 1.

<sup>306</sup> Axelrod, Donald. Budgeting for Modern Government, 2nd ed., New York: Martin's Press, 1988, p. 240.

## PROPOSED ALTERNATIVES

### Status Quo

Although virtually all sources consulted agree on the need for reliability and integrity of financial data, there are some who argue that the current systems satisfies the needs of Congress and the federal managers who must account for the proper use of the nation's resources. They point out that there is no overwhelming, demonstrated need for private sector styled GAAP which is designed to account for and report on federal financial transactions in a way that allows decision-makers to judge the operational effectiveness of a business entity, because, in the public sector, the appropriation is the accounting entity. In addition, unlike the business sector, the federal government is not a for-profit entity, and therefore does not have this financial "bottom line" on which to judge its effectiveness. The mission of the federal government is to promote the general welfare, provide for the common defense, and provide other services using investments and assets whose return is difficult to measure in quantifiable terms.

### GAAP Based on FASB Standards

Proponents state that since the government is a business, it should account for and report on transactions in the same manner as the private business sector. As such, it should have a double entry accrual accounting system, a standard general ledger with uniform chart of accounts, and should prepare annual general purpose financial statements that are audited and certified as in compliance with GAAP.

### GAAP Based on GASB Standards

This system would be similar to what currently exists in some federal agencies, where accrual accounting is maintained where there is a need, such as for the DOD industrial fund entities. Other appropriations and funds would continue to be maintained on a cash basis, with financial reporting being based on full disclosure of assets and liabilities in a single integrated accounting system.

### GAAP Based on Unique Federal Government Standards

It has been pointed out that the federal government currently has its own generally accepted accounting principles in the form of GAO Title 2. These principles, which with the 1984 revision, are essentially a mirror of FASB GAAP, have not been followed, as such, in the federal government. There are those who argue that the reason they have not been followed is because

they do not apply to the federal sector. As such, they argue that the federal government should have a new system of principles and standards designed to take into consideration the uniqueness of the federal government.

#### Cost Accounting System (Non-Standard)

In this system, instead of cost being linked to expenses, it could be linked to obligations or otherwise based on the cash-based accounting system. [The author is not a technical expert in this area or on this issue, but includes it as posed to her for consideration and possible research by others.]

#### Integrating the Accounting and Budgeting System on an Accrual Basis

In an article criticizing the AICPA's Discussion Memorandum on improving federal financial management<sup>307</sup>, Robert N. Anthony states that the focus of the Discussion Memorandum on the accounting system is wrong, and its recommendations, if adopted, would accomplish little. He indicates that the focus should be on the budget system since "agencies pay great attention to the budgetary reporting because it is tied to the source of their funds -- the power of the purse predominates."<sup>308</sup> He further states that as long as the accounting system is inconsistent with the budget system, there will not be an environment for compliance with the GAO standards and principles<sup>309</sup> [author's emphasis.] He concludes that:

Congress should appropriate operating expenses according to the same principles that the AICPA Task Force recommends for the accounting system. It follows that the solution is to change the budget principles, not the accounting principles.<sup>310</sup>

On the other side of the issue, Phillip S. Hughes, in a comment on a paper of the federal budgetary process by Louis

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<sup>307</sup> American Institute of Certified Public Accountants. Federal Financial Management: Issues and Solutions, Discussion Memorandum, by the Task Force on Improving Federal Financial Management, 1989.

<sup>308</sup> Anthony, Robert N. "The AICPA's Proposal for Federal Accounting Reforms." Management Accounting, July 1990, p. 50.

<sup>309</sup> Ibid., p. 49.

<sup>310</sup> Ibid., p. 51. [Anthony views these principles as being accrual based for the budget as well as for the accounting system].



Fisher, states that in order to simplify the budget process, it should be completely divorced from accounting and use indicators of policy trends to "make the numbers easier to handle and easier for the public to understand."<sup>311</sup>

#### Chief Financial Officer (CFO)

Although not actually a proposal for an alternative financial management system, the idea of a CFO to spearhead financial system reforms is one of the concepts endorsed by the GAO, OMB, AICPA, and the FEI. The CFO is discussed here because of the debate as to what the qualifications of such a position should be.

Per Robert N. Anthony, "the term "chief financial officer" is a misnomer. At most, the functions of the position described in the Task Force report<sup>312</sup> are those of a chief accounting officer."<sup>313</sup> He feels that the functions prescribed for a CFO are already performed by Treasury and OMB, but "if there is a CFO, he or she should serve at the pleasure of the President" so that agencies understand the CFO has the backing of the President. Robert Harris, the controller of IBM Credit Corp. agrees that the CFO should have cabinet rank, be appointed by the President, and be confirmed by the Senate.<sup>314</sup> In addition, the concept of a CFO is supported by the GAO, OMB, AICPA, and the FEI.

Clyde E. Jeffcoat, Jr., in an article detailing the standards needed for financial management personnel, holds that "many of our most senior financial managers do not understand

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<sup>311</sup> Hughes, Phillip S. Comment on paper by Louis Fisher. "The Budgetary Process: How Far Have We Progressed?", Brookings Dialogues on Public Policy, Brookings Institution, Washington, D. C., 1982., p. 87.

<sup>312</sup> American Association of Certified Public Accountants. Federal Financial Management: Issues and Solutions, Discussion Memorandum, by the Task Force on Improving Federal Financial Management, 1989.

<sup>313</sup> Anthony, Robert N. "The AICPA's Proposal for Federal Accounting Reforms." Management Accounting, July 1990, p. 48.

<sup>314</sup> Harris, Robert, interview with. "The Time Has Come for Federal Financial Reform." Financial Executive, January/February 1990, p. 58.

accounting."<sup>315</sup> He concludes that the CFO should be a qualified accountant. In a comment on Jeffcoat's article, William T. Furman takes the opposite tack.<sup>316</sup> Furman indicates that the CFO should not be narrowly focused; he should not be a "techn[o]crat". Instead, he suggests flexibility is important, and familiarity with all areas of financial policies.<sup>317</sup> A 1928 article on the importance of the Controller, by R. B. Kester states that the primary requirement is to be first of all a business man; the secondary requirement is to be a skilled accountant.<sup>318</sup>

### Financial Management Legislation

Many of the proponents for GAAP (as currently structured in the private sector) for the federal sector, and the concept of a CFO, also promote the idea that legislation to enact both concepts will ensure that they are followed. As indicated earlier in this paper, the mere fact that an action is mandated by law will not ensure that it is followed (e.g., the accrual accounting and cost-based systems required by the Budget and Accounting Procedures Act of 1950 that are not followed today.) The important point to remember here is that in order for a law to be followed, it must either be formulated for an already acceptable idea, or it must "have teeth" in the form of the sanctions entailed in, for example, the Antideficiency legislation.

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<sup>315</sup> Jeffcoat, Clyde E., Jr. "Needed: Higher Professional Qualification Standards." Government Accountants Journal, Winter 1987/1988, p. 11.

<sup>316</sup> Furman, William T. "Higher Professional Standards--A Different View." Government Accountants Journal, Summer 1988.

<sup>317</sup> Dr. Jim Rotherham of American University indicates that most budget professionals tend not to be accounting-oriented, but have varied academic backgrounds. He considers this a plus, as in the financial world, one must be flexible to survive because the rules are constantly changing. He feels that accountants, however, follow rigid rules and standards and tend not to be as flexible. [It would seem that this logic could also apply to CFO's who should know something about all aspects of the financial management arena.]  
Rotherham, Dr. James, Director, Public Financial Management Program, American University. July 13, 1990, by telephone.

<sup>318</sup> Kester, R. B. "The Importance of the Controller." Accounting Review, September 1928, p. 250.

## Core Financial System Requirements

The JFMIP has produced a document entitled Core Financial System Requirements. This document establishes minimum uniform financial management system requirements, and the recommendation that its recommendations be incorporated in GAO's standards and principles, OMB Circular, and Treasury's reporting requirements.<sup>319</sup>

## Defense Management Resources Initiatives

In responding to the GAO financial audit of the Air Force, the DOD Comptroller, Sean O'Keefe, indicated that management initiatives formulated during the FY 1990/1991 budget cycle would solve many of the problems addressed by GAO in its audit. In forwarding the DOD comments on the Air Force financial audit, O'Keefe included the following note to the Assistant Comptroller General, Donald H. Chapin:

Also enclosed is the FY 91 budget justification material which specifically address the Department's finance and accounting initiatives stemming from the Secretary's Defense Management Report to the President. Through these initiatives we intend to get after precisely the issues raised in your findings.<sup>320</sup>

The Defense Management Reports (DMRs), a recent set of initiatives by the DOD, are intended to consolidate similar functions such as information systems for financial management and inventory management. They are designed to produce standardization, and streamlining in the management of defense resources, and are designed to "adopt all of the recommendations previously made by the Packard Commission."<sup>321</sup> There are four initiatives related to financial management 1.) consolidation of accounting and financial operations, 2.) development of a cost per output measure for functional areas such as base operations, and depot maintenance, 3.) creation of a standard accounting classification code, and 4.) development of integrated, standardized procedures and mechanisms for automated support to "improve the way the Department collects, uses and manages

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<sup>319</sup> Joint Financial Management Improvement Program. Core Financial System Requirements, January 1988, preface page 2.

<sup>320</sup> U. S. General Accounting Office. Air Force Does Not Effectively Account for Billions of Dollars of Resources, Financial Audit, Report to the Congress, GAO/AFMD-90-23, February 1990, p. 102.

<sup>321</sup> Joint Financial Management Improvement Program. JFMIP NEWS, Spring, 1990, p. 7.

information".<sup>322</sup> This last initiative, called Corporate Information Management (CIM), is operating under a group of executive-level experts from outside of the DOD [author's emphasis]<sup>323</sup> to develop integrated, automated support for such functional areas as financial operations and material management. The time frame for the implementation of these initiatives ranges from a few months to approximately 3 years.<sup>324</sup>

There are those, however, who question whether these initiatives alone are the answer. In the "Agency Comments" section of the report on the Air Force financial audit, GAO indicates that "the Defense Management Report describes the efforts to achieve the initiatives' objectives in broad, general terms. It does not contain detailed plans or milestones of the specific actions that would be required to successfully implement the initiatives."<sup>325</sup> <sup>326</sup> Additionally, in his testimony before the House on the Air Force financial audit, the Comptroller General, when asked whether he thought the Defense Management Resources initiatives would institute the changes he was recommending as a result of the Air Force financial audit, replied that he was not satisfied that the DMR by itself would be the solution to the findings identified in the audit, but felt more reassured by Secretary of Defense Atwood's and Mr. O'Keefe's reassurance of support. He indicated he did not feel that DOD

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<sup>322</sup> Ibid., p. 7.

<sup>323</sup> The author wonders if the way to get consensus is to bring in a group composed entirely of members from outside of the organization to propose changes for that organization. It is hoped that the results of the efforts of the outside experts will be thoroughly tested and demonstrated inside of the DOD to ensure acceptability and acceptance prior to any changes being instituted.

<sup>324</sup> Ibid., p. 7.

<sup>325</sup> U. S. General Accounting Office. Air Force Does Not Effectively Account for Billions of Dollars of Resources, Financial Audit, Report to the Congress, GAO/AFMD-90-23, February 1990, p. 7.

<sup>326</sup> There is a draft report by DOD extensively addressing the operational aspects of the findings and recommendations contained in the GAO audit of the Air Force. That report was not available to the author at the time this paper was written.

was "committed to the annual audit feature" which he feels is crucial to ensuring that needed changes are implemented.<sup>327</sup>

### INTERVIEW HIGHLIGHTS

The following section includes significant highlights of numerous interviews conducted by the author with professionals and academicians in the fields of financial management and accounting. As indicated earlier in the paper, the interviews were conducted to gain insight regarding the specificity of how the GAO proposed GAAP-based accounting system would improve financial management and decision-making in the federal government, specifically Defense. The questions asked concerned whether or not GAAP had relevance to the public sector; whether anyone could provide examples, studies, or analyses specifically demonstrating how information provided by GAAP-based systems as opposed to information provided by cash-based systems would be used in decision-making; and whether any cost/benefit analyses had been done on the prospect of converting federal systems.<sup>328</sup> As a whole, the interviewees did not generally address the specific example question, or the cost/benefit analysis question. All interviewees, however, did address the question of the relevance of GAAP and accrual based financial management systems to the public sector.

Major points of the interviews are presented, not as an attempt to characterize the interviewees' comprehensive position on the federal financial improvement issue, but to enlighten the reader as to the intricacies of the issues, and the diversity of views that exist on those issues.

#### The Definition Of, and the Need for GAAP

In the course of interviewing, it became clear that when one asks whether GAAP has application for the federal sector, the definition of GAAP takes on varying meanings. In addition, there is no clear definition of what specifically is meant by GAAP for

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<sup>327</sup> U. S. Congress. House. Air Force Financial Management Systems: Hearing before the Subcommittee on Readiness. Committee on Armed Services. March 8, 1990, pp. 55 & 67.

<sup>328</sup> The questions were formulated in this manner because the author was unable to discern such information from the literature.

the federal sector<sup>329</sup> [author's emphasis.] Many interviewees had different views as to whether it is envisioned that federal sector GAAP should be more closely modeled after that of FASB established GAAP in the private sector, GASB established GAAP for state and local governments, GAAP as currently proposed by the GAO in the form of Title 2, or an entirely new unique set of GAAP for the federal sector.

Some interviewees were emphatic in their support of GAAP, while others felt that it had no beneficial application. When asked whether GAAP had application for the public sector, particularly Defense, Virginia Robinson, Executive Director of the JFMIP, for example, indicated that the federal government should follow GAAP. Ms. Robinson stated that the government should follow the same type of principles as the private sector, because cost and effectiveness cannot be measured on the cash basis, but must be measured on the accrual basis.<sup>330</sup>

Another strong proponent of the instituting of GAAP-based systems in the federal sector including DOD is Bert Edwards, partner at Arthur Andersen and Co. Mr. Edwards indicated there is no reason not to institute GAAP in the federal sector. When asked how such information would affect decision-making in Defense, Mr. Edwards stated that for DOD purchases, decisions should be made from an economic perspective. For example, one should pump dollars into the economy when it is down, e.g., buy ships when the economy is down. When the economy is up, however, one should be judicious in purchasing such ships as this will not help the economy.<sup>331</sup>

When the author asked Marvin Phaup of the Congressional Budget Office whether he thought GAAP-based financial systems had application in the DOD, Mr. Phaup indicated that the concept of GAAP is not well-defined, [different principles and standards for private, and for state and local entities] and in discussing

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<sup>329</sup> Although GAAP for the federal sector is currently embodied in GAO's Title 2, most interviewees did not refer to this fact. They generally began to address the GAAP issue by discussing whether FASB or GASB GAAP would seem to be the more applicable to the federal sector, or whether the federal sector needed its own version of GAAP.

<sup>330</sup> Robinson, Virginia, Executive Director, Joint Financial Management Improvement Program. May 30, 1990, by telephone.

<sup>331</sup> Edwards, Bert, Partner, Arthur Andersen and Co. May 24, 1990, by telephone.

GAAP, one should be specific as to what one meant.<sup>332</sup> Arnie Weiss of the Office of the Comptroller of the Navy provided support for this viewpoint. Mr. Weiss stated that GAAP-based systems needed to be more clearly defined to ensure that all parties are talking about the same accounting transaction treatment.<sup>333</sup>

Further enforcing this area of uncertainty surrounding the idea of GAAP, Joseph Moraglio, Vice President of the AICPA, stated that in its Discussion Memorandum on federal financial management, the AICPA does not refer to GAAP because GAAP means different things to different people, and because of its negative connotations resulting from its associations with the commercial accounting model. Mr. Moraglio specified that whatever standards are developed for the federal sector should be unique to the federal sector [author's emphasis.] He indicated that these unique standards might even entail different reporting requirements.<sup>334</sup>

### The Political Nature of Decisions

On the opposite side of the scale from those individuals such as Mr. Edwards who are proponents of the economic approach to federal decision-making, however, are those who hold that federal, and especially Defense decisions, are not economically-based, but are instead politically-based. Charles P. Nemfakos, Associate Director of the Office of Budget and Reports in the Office of the Navy Comptroller states that in Defense, the proposal is national security. The issue, he continues, is not based on an economic flywheel with one making decisions based upon economic prudence.<sup>335</sup>

Anthony McCann, Assistant Secretary for Finance and Planning at the Department of Veterans Affairs, lends further credence for the proposition that decisions are political. He indicates that we lose dollars in programmatic decisions, not because of accounting problems. He gives some examples to support his

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<sup>332</sup> Phaup, Marvin, Unit Chief of Management Process Unit, Congressional Budget Office. June 14, 1990, by telephone.

<sup>333</sup> Weiss, Arnold, Executive Assistant Comptroller for Financial Management Systems, Office of the Comptroller of the Navy, June 14, 1990, by telephone.

<sup>334</sup> Moraglio, Joseph, Vice President, American Institute of Certified Public Accountants. June 8, 1990, by telephone.

<sup>335</sup> Nemfakos, Charles P., Associate Director, Office of Budget and Reports, Office of the Comptroller of the Navy, June 7, 1990, the Pentagon, Washington, D. C.

position, one of which is the recent Housing and Urban Development or "Robin HUD" scandal. Mr. McCann states that most of HUD's problems were not because of poor financial systems, but were because of poor program decisions.<sup>336</sup>

Dr. Jim Rotherham of American University, in a rather colorful description of the political nature of the decision-making process, states that when all is said and done, although Defense has an elaborate process to determine the budget, what the whole issue comes down to is a matter of "political pork". The cutting of the pork comes first, with each service getting a share. Then the Hill and the Defense industries spread the dollars among the states of the legislators.<sup>337 338</sup>

#### Alternative Approaches to Federal Financial Management Reform

Some of the interviewees postulated that many of the benefits ascribed to GAAP could be accomplished using slight modifications of current procedures, or procedures other than accrual accounting.

Roger Greene, retired Deputy Branch Chief of OMB Resource Systems Branch, indicated that a cost accounting system using a form of recorded obligations would be one systems approach to improved financial management. In such a system, obligations would be recorded as costs and tied back to the appropriations.<sup>339</sup> Along those same lines of thought, Tony Tisone of the Office of the Comptroller of the Navy, CPA, and formerly of Price Waterhouse, stated that a cost accounting system could be cash- and obligation-based and would not have to

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<sup>336</sup> McCann, S. Anthony, Assistant Secretary for Finance and Planning, Department of Veterans Affairs. June 12, 1990, by telephone.

<sup>337</sup> Rotherham, James, Director, Public Financial Management Program, American University. July 13, 1990, by telephone.

<sup>338</sup> An excellent example of this political pork idea of the sharing of the resources, is the B-1 bomber. The legislators supporting the bomber, in order to ensure it would not be cut from the budget, made sure that each and every state had some share of the business of producing the B-1. The author presumes that, had politics not been an overriding factor, a more integrated economical procurement strategy could have been followed.

<sup>339</sup> Greene, Roger, Deputy Branch Chief (Ret.), Resource Systems Branch, U. S. Office of Management and Budget. June 6, 1990, by telephone.



rely on accrual accounting. He indicated that such a system would promote the desired goal of accountability and comparability among services.<sup>340 341</sup>

### Financial Reporting Would Force Improved Internal Systems and Controls

Key people in the GAO<sup>342</sup> feel that by instituting GAAP and, in effect, forcing financial reporting, the mechanism for ensuring that the underlying systems are effective would be accomplished. Dennis Duquette stated that in considering whether GAAP-based systems should be instituted in the federal government, one should not focus entirely on how such systems would affect decision-making. He indicated that requiring comprehensive reporting would prove that the underlying systems were reliable, and by having reliable data, would thus contribute to the oversight process.<sup>343</sup> Further, Dave Connor stated that if systems can produce auditable statements, they can produce data that can allow comparisons.<sup>344</sup> Finally, Ron Young indicated that, even if the standards on which such financial systems and reporting were based were less than perfect, the fact that they existed and had to be uniformly followed would, in and of itself, force reliable, dependable systems.<sup>345 346</sup> When asked how the

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<sup>340</sup> Tisone, A. A., Jr., Director, Resource Allocation and Analysis Division, Office of Budget and Reports, Office of the Comptroller of the Navy. June 5, 1990, Crystal City, Arlington, VA.

<sup>341</sup> The author is not a technical expert in this area, but includes this example as a basis for research for others who may be interested.

<sup>342</sup> Some outside of GAO echoed this same sentiment. John Nabil of the Army indicated that using an already established discipline, such as GAAP, makes it easy to manage. Nabil, John, Director of Finance and Accounting Policy, Department of the Army. June 14, 1990, by telephone.

<sup>343</sup> Duquette, Dennis, Director, Financial Audits of Civilian Agencies, U. S. General Accounting Office. June 4, 1990, by telephone; June 27, 1990, U. S. General Accounting Office, Washington, D. C.

<sup>344</sup> Connor, Dave, Director, Defense Audits, U. S. General Accounting Office. June 4, 1990, by telephone.

<sup>345</sup> Young, Ronald. S., Director, Accounting Principles and Standards Group, Accounting and Financial Management Division, U. S. General Accounting Office. June 27, 1990, U. S. General Accounting Office, Washington, D. C. (continued...)

information generated from systems operating under the proposed reformed standards would help decision-making, Mr. Young stated that, although not sure at this point of exactly how a GAAP-based system would affect decision-making, through an evolutionary usage process where different alternatives could be realized, the system would ultimately affect decision-making.<sup>347</sup>

Further illustration of the support for the position of the requirement for financial reporting causing the supporting systems to be effective, or in the words of the author, the "tail wagging the dog" type of approach, Bert Edwards, in a letter to the author, states:

The knowledge of accountability to sources external to the organization itself promotes discipline, management, concern, and accuracy.<sup>348 349</sup>

As illustration for this point, Mr. Edwards recounts the challenge of President Kennedy to "put a man on the moon in ten years." In arguing that, had President Kennedy not issued such a challenge, we would not yet have landed on the moon,<sup>350 351</sup> and

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<sup>346</sup> From the same perspective, Tom McCarty of the DOD indicated that although the federal government might not necessarily need GAAP, per se, it needs the discipline associated with producing a financial statement. McCarty, Thomas, Deputy Director, Accounting Policy, Office of the Comptroller of the DOD. June 7, 1990, the Pentagon, Washington, D. C.

<sup>347</sup> Young, Ronald. S., Director, Accounting Principles and Standards Group, Accounting and Financial Management Division, U. S. General Accounting Office. June 27, 1990, U. S. General Accounting Office, Washington, D. C.

<sup>348</sup> Edwards, Bert, Partner, Arthur Andersen and Co. Letter to author, May 25, 1990, p. 1.

<sup>349</sup> The federal government is currently held accountable to external sources, e.g., the Congress. However, since the Congress is the federal government's "banker" through the appropriation committees, and the banker is concerned primarily with cash management, the incentive for financial reporting does not currently exist.

<sup>350</sup> The author maintains that the primary reason for being able to meet this challenge hinged on the total commitment of the Executive and Legislative Branches to the providing of resources to meet the challenge -- this top level commitment to improving federal financial systems does not currently exist, and  
(continued...)

paralleling the Kennedy illustration to a current President campaigning on the goal of accountability, being able to galvanize the U. S. Government into issuing:

reasonably accurate and auditable financial statements; perhaps the first set would take nine months, then six months after several years, then three months. Hopefully, we could eventually attain what Arthur Andersen calls for in focusing the State of the Union Address on the Audited Financial statement of the nation--approximately 100 days after the end of the fiscal year.<sup>352</sup>

#### The Need to Educate Users of Proposed Financial Statements

Some of those interviewed pointed out the need to educate the users of financial statement information to ensure that it would be used. John Nabil of the Army stated that reports from a system are useful only if managers understand how to use them.<sup>353</sup> Nelson Toye of the DOD provided further emphasis by indicating that producing financial statements is not the end of the process; you must educate people in the use of the financial statements.<sup>354</sup>

#### On the Issue of Depreciation

On the subject of depreciation, especially as regards the DOD, interviewees had very mixed approaches. There were those who felt that depreciation should apply with few exceptions. Dave Connor of the GAO indicated that capitalizing major weapon

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<sup>350</sup>(...continued)  
without the Executive and Legislative Branches totally committed to financial reform, the financial management "challenge" cannot be issued and met.

<sup>351</sup> In a rather "tongue-in-cheek" column on the nature of U. S. competitiveness, Richard Cohen points out that the reason the U. S. met the challenge to put a man on the moon was because the U. S. could not stand the idea of being outdone by the Soviet Union, i.e. that competition was the driving force. Cohen, Richard. "Put Up Your Dukes, Nippon", Critic at Large, The Washington Post Magazine, July 15, 1990, p. 5.

<sup>352</sup> Ibid., pp. 1-2.

<sup>353</sup> Nabil, John, Director of Finance and Accounting Policy, Department of the Army. June 14, 1990, by telephone.

<sup>354</sup> Toye, Nelson, Director, Accounting Policy, Office of the Comptroller of the DOD. June 21, 1990, by telephone.

systems and depreciating would help external parties rather than internal managers.<sup>355</sup> Tom McCarty of the DOD stated that depreciation is valid and necessary for a better focus and to correlate with the logisticians on the remaining value of assets. Mr. McCarty, when asked how such information would affect decisions, however, indicated that it probably would not affect decisions, but that the private sector did not use such information in making decisions, either.<sup>356</sup>

Of those who felt that depreciation was either unnecessary or of limited value in defense, Greg Hanson of the Treasury indicated that, for all intents and purposes, military hardware is, by definition, already expendable and that no one is going to keep statistics on, for example, how many times the Iowa's guns have been fired.<sup>357</sup> John Nabil of the Army echoed this sentiment in asking, from the operational standpoint, what the purpose of such information on tactical equipment and systems would be.<sup>358</sup> Cornelius E. Tierney expressed an even stronger position on the issue of depreciation for the federal government. Mr. Tierney stated that, unless the asset was a wasting asset, you may be distorting the accounting by depreciation, a gimmick that came about because of the IRS.<sup>359</sup>

#### The Need for Agency Operational Data

Many of the professionals interviewed indicated the need for agency operational data. Dennis Duquette of the GAO stated that knowing the cost of operations over time is important for making comparisons, e.g., in demobilizing, what is the cost of an air wing in Omaha as opposed to one in Jacksonville.<sup>360</sup> Clyde

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<sup>355</sup> Connor, Dave, Director, Defense Audits, U. S. General Accounting Office, June 4, 1990, by telephone.

<sup>356</sup> McCarty, Thomas, Deputy Director, Accounting Policy, Office of the Comptroller of the DOD. Interview with author, June 7, 1990, the Pentagon, Washington, D. C.

<sup>357</sup> Hanson, Greg, Senior Systems Accountant, Financial Management Service, U. S. Department of the Treasury. May 30, 1990, by telephone.

<sup>358</sup> Nabil, John, Director of Finance and Accounting Policy, Department of the Army. June 14, 1990, by telephone.

<sup>359</sup> Tierney, Cornelius, Partner, Ernst and Young. May 25, 1990, by telephone.

<sup>360</sup> Duquette, Dennis, Director, Financial Audits of Civilian Agencies, U. S. General Accounting Office. June 4, (continued...)

Jeffcoat of the Army, and president elect of the AGA, indicated that having reliable information with which to compare operations and the relative productivity of units, using efficiency and qualitative measures, is important. As an example, he stated that you cannot currently compare the cost of overhauling helicopters in the Navy as opposed to the cost of overhauling helicopters in the Army because the data bases for each service are different.

Nelson Toye of the DOD goes even further in stating that what is needed is the operating cost per weapon system so that more cost effective decisions on buying weapons can be made.<sup>361</sup> From a slightly different vein, Dave Gribble of OMB states that knowing the cost of operations could be useful, but that GAAP is not necessary to determine such cost -- that it could be defined based upon obligations or outlays.<sup>362</sup>

Regarding the cost of operations, Charles P. Nemfakos of the Office of the Navy Comptroller, however, argues to the contrary regarding the above stated position. Mr. Nemfakos states that a system of cost for comparability could be valid if all operations were based and utilized in the same manner, and had the same mission as well. He argues, by example, that this is not the case when comparing two squadrons. Mr. Nemfakos questions the value of the analysis when comparing an attack squadron, with a nuclear capability, with an attack squadron with a conventional capability. Indicating that the launch platforms are different, he states that there are no simple analogies and valuations, and thus no simple way to compare operational data for the purpose of making strategic decisions regarding the different entities.<sup>363</sup> [Although purely economic decisions could be made if the choice was made to ignore Defense and/or other federal missions.]

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<sup>360</sup>(...continued)  
1990, by telephone; June 27, 1990, U. S. General Accounting Office, Washington, D. C.

<sup>361</sup> Toye, Nelson, Director, Accounting Policy, Office of the Comptroller of the Department of Defense, June 21, 1990, by telephone.

<sup>362</sup> Gribble, Dave, Senior Financial Management Analyst, U. S. Office of Management and Budget. June 6, 1990, by telephone.

<sup>363</sup> Nemfakos, Charles P., Associate Director, Office of Budget and Reports, Office of the Comptroller of the Navy, June 7, 1990, the Pentagon, Washington, D. C.

## Trend Analysis

There were interviewees who argued that the statistical data that would be generated from a GAAP-based system could be used for trend analysis. Greg Hanson of the Treasury stated that GAAP would provide trend analysis with more statistical information from the full cost perspective.<sup>364</sup> On the other hand, there were those who felt such information would be less than useful.

Chris Hendricks of the DOD IG indicated that, under the present DOD systems, DOD knows the cost of its equipment and can gather such data to do trend analysis now. Mr. Hendricks further stated that the reason such analyses is not currently done is because Congress does not work that way [use such scientific analyses as a basis for decision-making] -- it chooses what to buy, what rates to charge, etc. The decision process, he continued, is a political, not a scientific process.<sup>365</sup>

## Asking the Right Questions and Getting the Right Answers

There were some of the professionals interviewed who indicated that the problems attributed to poor financial management were not related to systems, but to a level of effort in getting the right information.<sup>366</sup> Others emphasized the need to identify the right information necessary for management decisions. Marvin Phaup of the Congressional Budget Office stressed the need for better management accounting systems, an area, he indicated, on which GAAP does not focus. Mr. Phaup further stated that what needs to be examined is the decision functions that would be supported by any financial system reforms.<sup>367</sup>

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<sup>364</sup> Hanson, Greg, Senior Systems Accountant, Financial Management Service, U. S. Department of the Treasury. May 30, 1990, by telephone.

<sup>365</sup> Hendricks, Christian, Technical Director for Planning and Policy, Office of the Department of Defense Inspector General; President, Washington Chapter, Institute of Internal Auditors. May 30, 1990, Crystal City, Arlington, VA.

<sup>366</sup> Hendricks, Christian, Technical Director for Planning and Policy, Office of the Department of Defense Inspector General; President, Washington Chapter, Institute of Internal Auditors. May 30, 1990, Crystal City, Arlington, VA.

<sup>367</sup> Phaup, Marvin, Unit Chief of Management Process Unit, Congressional Budget Office. June 14, 1990, by telephone.

Ed Rea of OMB provided further reinforcement for identifying the specifics of what information is needed, by whom, and for what purpose, by stating that there is no general agreement on what the problem is to begin with. Mr. Rea indicated that the idea of different measurement concepts and more auditing to instill discipline make sense, however, he questioned the value to be added from an improved system and the generation of information when there is already so much information floating around that is not used because no one really needs it or does not know how to use it.

#### Usefulness of Data Generated

On the idea of usefulness, many interviewees pointed out the need to define specifically how the proposed reforms will be useful. Charles P. Nemfakos of the Navy stated that there are a multiplicity of ways to cut the data, however, such different cuts represent a very costly proposition. Therefore, if there is no cost to produce this more complex proposed operation, then why not implement the proposed reforms. As there is a cost, however, one must examine the value added. Statistics and data can be multiplied, divided, added, etc., but, he asked, who will use the data, and for what purpose.<sup>368</sup> Dr. Jim Rotherham of American University underscored this point by indicating there is no virtue in tying up scarce public resources unless the information to be gathered is to be useful and is used.<sup>369</sup>

Joseph Moraglio, Vice President, American Institute of Certified Public Accountants, went even further in questioning the current approach to federal financial management reform. Mr. Moraglio indicated that, for the federal government, a specific governmental system should be developed based upon needs which have yet to be succinctly delineated. He stated that the idea of GAAP-based systems should not be "pushed" as the only approach to federal financial reform.<sup>370</sup> Cornelius E. Tierney, of Ernst and Young reinforced this perspective, indicating that for the federal government, a separate accounting system should

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<sup>368</sup> Nemfakos, Charles P., Associate Director, Office of Budget and Reports, Office of the Navy Comptroller, June 7, 1990, the Pentagon, Washington, D. C.

<sup>369</sup> Rotherham, James, Dr., Director, Public Financial Management Program, American University. July 13, 1990, by telephone.

<sup>370</sup> Moraglio, Joseph, Vice President, American Institute of Certified Public Accountants. June 8, 1990, by telephone.

be designed, based neither totally on cash nor totally on accrual accounting.<sup>371</sup>

Anthony McCann, indicating that financial standards do not help managers, stated that the problem is not one of accounting systems, but is a general legislative problem of not knowing what they [the legislators] want, and the agencies not knowing what they need. Consequently, he pointed that others have speculated that the emphasis on federal financial management reforms may be so that financial professionals can talk to other financial professionals though control of the financial systems.<sup>372</sup>

Ed Rea, Chief of the Resource Systems Branch of OMB underscored the need to examine the usefulness of data generated by proposed system reforms. Mr. Rea pointed out that the current GAO proposals are based on systems that were mandated by law over 40 years ago that were never put into effect because the data was not needed or used. Mr. Rea indicated that the specifics associated with the Budget and Accounting Procedures Act of 1950, and the Act as amended in 1956, never amounted to any major systems changes because it was never perceived as any more than supplementary information that was not truly needed. Therefore attention to the specific provisions of the bill regarding accrual accounting died for lack of interest.<sup>373</sup>

#### Accountability of Assets

Most of the interviewees agree on the need to provide full accountability for federal assets. Their responses are typified by that of Chris Hendricks of the DOD IG. When discussing why the government, because it has no control over such actions as pricing, does not use indicators such as return on investment, Mr. Hendricks indicated that the bottom line of federal control regarding assets is the responsibility for their accountability.<sup>374</sup>

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371 Tierney, Cornelius, Partner, Ernst and Young. May 25, 1990, by telephone.

372 McCann, S. Anthony, Assistant Secretary for Finance and Planning, Department of Veterans Affairs. June 12, 1990, by telephone.

373 Rea, Ed, Chief, Resource Systems Branch, U. S. Office of Management and Budget. June 22, 1990, by telephone.

374 Hendricks, Christian, Technical Director for Planning and Policy, Office of the Department of Defense Inspector General; President, Washington Chapter, Institute of Internal Auditors. May 30, 1990, Crystal City, Arlington, VA.



## CONCLUSION

### Federal Financial Management System Reforms are Needed

After examining material (i.e., literature and interviews) on all aspects of the federal financial management and reporting issue, in conjunction with many federal and private sector financial management professionals, I believe that there is a need for modernization and standardization of the federal financial management structure. This fact becomes even more pressing given the rapidly changing world situation including such events as the Soviet peace initiatives, the disintegration of the Berlin Wall, and the increasing growth of the global economy. World shaping events such as these which affect the manner in which we employ our scarce resources, demand a unified, uniform federal approach to both operational and financial management. The need to rapidly respond financially to such circumstance as decreasing Defense resources, and global competition in the world financial market becomes crucial if we are to maintain our economic and political superiority.

There is consensus on the idea of standardization and reliability of financial management systems within the public sector. Virtually all written material, as well as the majority of interviewees, indicate that some form of standardized, reliable, timely information systems should exist within the entire federal government, so that meaningful comparisons could be made across agencies and programs, and so that there is control of all resources. From that point, however, there is wide divergence on the proper way to approach that standardization.

After years of what can best be categorized as a fragmented agency-based approach to financial management system development, with no clear centralized oversight or direction of that development, there is a pressing need for a unified federal accounting and reporting system. Each agency of the federal government should be using standardized accounting and budgeting terminology, operating under that same basic accounting and budgeting structure, and reporting in a consistent manner from integrated systems which automatically, or through an automatic "cross-footing" system, feed into the standardized accounting and reporting system.

### Reforms Must Have Consensus and Be Demonstrated as Useful and Necessary

Whatever changes are ultimately made to the federal financial management system structure must have the consensus of the Congress, the OMB, the Treasury, the GAO, and the federal agencies. In addition, the changes should be demonstrated as

useful, not only to outside users, but to day-to-day agency operating managers [both of whose specific needs have yet to be succinctly identified.]

GAAP, As Currently Structured, Not Demonstrated as the Best Approach

Based on the divergence of professional views on the possible approaches to that standardization, the fact that the current private sector GAAP-based accounting model is also being examined as needing modification in light of changing information needs, and the fact that for 40 years, the federal government is supposed to have been operating under a system that the GAO has been pushing hard to have implemented, I question whether there is a clear and pressing need for the federal financial management changes as currently proposed by the GAO.<sup>375</sup>

In point of fact, it might be possible that the federal financial management system initiatives proposed by GAO could be the best approach to financial management reform. However, the need for the data that the GAO asserts is needed, as well as the usefulness of the data gathering, accounting, and reporting as structured by the GAO, and the benefits as opposed to the costs of designing and implementing such a structure, have not been demonstrated.

Further, in demonstrating the "worth" of the GAO proposed reforms, the magnitude of the political nature of the budget and decision process has largely been ignored. Any proposed financial management system reforms must be geared towards not only the needs of executive agency management, but towards the requirements for information by the Congress, the ultimate decision-maker [the "banker", if you will] in the federal government.

Considering the political nature of decision-making, it should be realized management decisions cannot be imposed by use

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<sup>375</sup> I also question whether, when the statute to adopt an accrual accounting system was set up on the books in 1950, the Congress truly understood what was meant by an accrual accounting system. The financial climate at the time of enactment of the Budget and Accounting Procedures Act of 1950 was characterized by a growing government with hundreds of accounts all maintained by the GAO. Echoing the sentiments of Ed Rea of OMB (see page \_\_\_\_ of this paper), I suggest that in an attempt to streamline a cumbersome system, and to gain some means of financial control, Congress adopted the structure proposed by the GAO, unaware of its accounting and financial technicalities.

of an accounting vehicle. Because of the political nature of the decision-making process in the federal government, some practices such as the Congressional decision to not buy what the agency views as necessary to accomplish its mission, or to buy what the agency views as unnecessary cannot be controlled by the accounting system, no matter its structure.

Further Research Needed on Possible Approaches to Federal Financial Management System Reforms

As previously indicated, the diversity of opinions on, and approaches to, the issue of what needs to be done to improve federal financial management systems begs the question of what aspects [if any] of the many considerations and proposed approaches might have application. The author concludes that none of these suggestions and proposals should be rejected until thoroughly investigated, and compared with the current federal system.

## RECOMMENDATIONS

### 1. Survey of User Needs Should Be Conducted

I propose that more research is needed regarding the specific needs and requirements of users of federal financial information before any standards and principles are proposed for federal financial accounting, reporting, and management. In fact, given the FGRS<sup>376</sup> which showed that usefulness of federal sector financial statements was limited, and the GAO's acknowledged need for assessing the users needs when developing financial systems,<sup>377</sup> assessment of user needs would be among the primary considerations before undertaking any effort to reform the current systems.

The question of the usefulness and meaningfulness of any proposed data to be promulgated to the public is especially significant given the recent Washington Post article<sup>378</sup> stating that the accuracy and value of U. S. statistics are being questioned by economists. The article states:

In studying government data, everyone from the National Academy of Sciences to the National Association of Business Economists has reached the same conclusion--there are serious problems regarding the accuracy and usefulness of the statistics.<sup>379</sup>

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<sup>376</sup> U. S. General Accounting Office Joint Study with Auditor General of Canada. Federal Government Reporting Study, Summary Report, GAO/AFMD-86-30, March 21, 1986.

<sup>377</sup> U. S. General Accounting Office. Survey of Cost Accounting Practices at Selected Agencies, GAO/AFMD-90-17, February 1990, p. 8. In order to obtain information on the characteristics of cost accounting systems in the federal government, the GAO conducted two surveys which were sent to individuals responsible for providing cost information. GAO states "We did not obtain the views of users of cost accounting data as part of this survey. Such data on the information need of federal managers would be useful in order to further develop cost accounting systems responsive to these needs."

<sup>378</sup> Crutsinger, Martin. "Economists Question Accuracy and Value of U. S. Statistics." Washington Post, Business Section, July 5, 1990.

<sup>379</sup> Ibid., p. D1. Although this article is primarily concerned with the reporting of economic indicators, the sentiments expressed in the article could as easily be echoed for  
(continued...)

Proponents of current and proposed GAAP-basis financial reporting for federal government indicate that users of government financial reports are not getting the information they need in the format that they need it. This assertion, however, does not address what specifically users need that they are not getting. As previously indicated, the overall results of the FGRS, the only survey the author found of user needs for general purpose financial statements, indicated that of the three groups surveyed,<sup>380</sup> the most frequent users of general purpose governmental financial statements were media and analysts. If there is no bona fide need at the legislator and government planner and manager level, one might question whether the move to produce such reports is necessary.

I therefore recommend a scientific survey of all potential internal and external users to determine their actual needs. The survey could be patterned after the GASB research report survey by Van Daniker and Kwiatkowski on whether or not, and how, infrastructure assets should be reported.<sup>381</sup> The survey addressed two issues, 1.) what type of information should be reported, and 2.) where should it be disclosed in the financial statement. The survey then provided an explanation and illustration of the different types of information that could be provided, with actual examples to illustrate how the data might appear. Each participant in the survey then rated each type of information as to its usefulness on a scale of from 1 - not useful to 7 - very useful. One of the most interesting survey results was that of the six types of information evaluated<sup>382</sup> for

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<sup>379</sup>(...continued)  
data that might be reported as representing the "true" financial condition of the U. S. government.

<sup>380</sup> U. S. General Accounting Office Joint Study with Auditor General of Canada. Federal Government Reporting Study, Summary Report, GAO/AFMD-86-30, 21 March 1986, p. 5. The three user groups included 1.) legislators, government planners and managers, 2.) citizens and corporations, and 3.) media and analysts.

<sup>381</sup> Van Daniker, Relmond P., and Vernon Kwiatkowski. Infrastructure Assets: An Assessment of the User Needs and Recommendations for Financial Reporting, Research Report, Governmental Accounting Standards Board, October, 1986.

<sup>382</sup> Ibid., p. 112, the six types of information were historical cost, replacement cost, constant dollar cost, budget to actual information, financial plans information, and engineering information.

their usefulness in meeting reporting and accounting objectives, the engineering information, a non-financial indicator, was deemed the most useful. Perhaps a structured survey of governmental financial information user needs might be equally revealing.

## 2. The Uniqueness of the Federal Government Should Be Fully Addressed

Although there were proponents of GAAP for the federal sector who did not seem inclined to vary from the basic principles of either FASB or GASB GAAP, most of the literature and interviewees acknowledged that some (and some thought that many) of the current GAAP standards would not apply to the federal government because of the uniqueness of its mission and operations. This uniqueness, whose surface was explored in this paper, should be thoroughly investigated and taken into consideration with the development of any standards and principles.

## 3. Case Studies Should Be Examined

Further research should be done using case studies of governmental entities and other not-for-profit enterprises that have attempted to convert to GAAP. The case studies should be of both successes and non-successes in order to assess how success should be judged, as well as what information is needed in order to plan and analyze. A case study on the Commonwealth of Kentucky's decision to adopt GAAP refers to the argument of R. S. Kaplan for case studies as follows:

...case study methodology is a prerequisite to formal modelling in managerial accounting. In that spirit, the authors believe case study research of governmental accounting disclosure practices is a prerequisite to fruitful model building efforts in government accounting research.<sup>383</sup>

Of note in the Kentucky case study to adopt GAAP is that the process of Kentucky converting to GAAP took eight years. Of further interest is that "Kentucky now has a new computerized accounting system that uses the GAAP fund structure and operates on a cash basis of accounting during the year,"<sup>384</sup> which is similar to the current federal financial management structure when converting from cash to an accrual basis for Treasury

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<sup>383</sup> Carpenter, Vivian L., and Ehsan H. Feroz. "The Decision to Adopt GAAP: A Case Study of the Commonwealth of Kentucky." Accounting Horizons, June 1990, p. 68.

<sup>384</sup> Ibid., p. 77.

financial statement reporting. It would therefore be of interest to study other entities' conversions to integrated GAAP financial systems to understand the specifics of what worked, what did not work, and suggestions from the entities as to what could be done to make conversions more effective.

From a slightly different perspective, but an example of a case study worth pursuing, Thomas J. Cuny writes of the difficulty encountered when, upon adoption of the unified budget, attempts were made to convert budget receipts from cash to an accrual basis.<sup>385</sup> He states that the effort to convert budget receipts is an integral part of GAO's proposals to:

convert budget accounting to a model based on business income statements. (Note: The GAO insists that its model is not a business model but one adapted to the nature of the federal government; my perception is to the contrary.) As already mentioned, shortly after adoption of the unified budget the OMB and Treasury tried to convert receipts to an accrual basis, but they were unable to develop a procedure to estimate the accruals data in a timely or reliable fashion, and the project was dropped.<sup>386</sup>

As further support for the need for case studies, in the 1987 Senate Committee on Governmental Affairs hearing on financial management, Deputy Director of GAO for the Accounting and Financial Management Division, John Cherbini, indicated that he had worked in the state and local government environment and that some of the state and local governments had developed good financial systems. Committee Chairman, Senator John Glenn, asked John Cherbini, the following:

Are there track records that would give us an indication of what can be done on this level or with what we are trying to do here where we could use different States as an example of what has happened?...I am not looking for a Sears Roebuck thick report from the States, but if you can give us summaries of how it was going along before and what

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<sup>385</sup> Cuny, Thomas J. "The Evolution of Accounting for Receipts in the Federal Budget." Public Budgeting and Finance, Winter 1989.

<sup>386</sup> Ibid., p. 34.

happened after and give us some good examples of what happened there, I would appreciate that.<sup>387</sup>

The GAO provided examples of several states' own broad description of and/or chronology of their systems,<sup>388</sup> or endorsements of and testimonials on the concepts of the GAO proposal for financial management reform (GAAP, CFO, etc.). However, in this instance, it is the author's opinion that hard facts regarding the previous systems' cost, the problems with the previous systems, the cost and time to institute new or revised systems, and the benefits of the new systems would have provided further support to the argument of the benefits of financial reform as proposed by the GAO.

#### 4. Specific Applications of How GAAP<sup>389</sup> Will Help Users of Financial Information Should Be Developed

The bottom line is that the arguments for changing to a GAAP-basis accounting and reporting system for the federal government appear to many as entirely too rhetorical and conceptual, and need to be backed up with specifics. Arguments such as:

What we need is simply the commitment of managers to "run the business of government like a business:, to make sound judgments based on timely, accurate financial data.<sup>390</sup>

The knowledge of accountability to sources external to the organization itself promotes discipline, management, concern, and accuracy.<sup>391</sup>

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<sup>387</sup> U. S. Congress. Senate. Financial Management. Committee on Governmental Affairs. Hearing. July 23, 1987, p. 14.

<sup>388</sup> Ibid., p. 165-168, for example, the state of Florida writes of a single accounting systems where "transactions are, for the most part, consistently recorded" (p. 165), and "for the 1983-84 fiscal year, combined Statewide financial statements, using mostly data obtained from SAMAS (the single system), were prepared, audited, and published." (p. 168). Such information is less than revealing about how much of the system is totally and effectively integrated.

<sup>389</sup> This would apply for GAAP, or any proposed alternative financial management system.

<sup>390</sup> Edwards, Bert, Partner, Arthur Andersen & Co., to the author, May 25, 1990, p. 2.

<sup>391</sup> Ibid., p. 1.



Periodic financial reporting in accordance with prescribed principles (presumably, GAAP) forces an organization to be disciplined in its record-keeping, its policies and procedures, and its personnel.<sup>392</sup>

need to be backed up with specifics in order to convince governmental agencies and other users of their merit. How specifically will the proposed changes to GAAP provide better data than is currently provided; and if such improved data is, in fact, available to managers, how will GAAP reporting promote discipline, concern, etc. to a system which is already held accountable to external sources. Admittedly, some of the arguments have inherent appeal, "gut-level" appeal in their apparent logic. If the federal government forces the private sector to operate under GAAP, why shouldn't it do the same. However, the statements of the benefits of GAAP-based accounting and reporting must be clearly demonstrated in order to be convincing. Could not some means or model other than GAAP ensure standardization and reliability in the federal sector?

As stated by Mautz regarding the need for private sector GAAP for the federal sector:

Before we urge that governmental accounting emulate business accounting--an oft-stated contention--we need to consider some of the differences. I have the strong feeling that we have not yet asked the right questions about those differences, so we have not obtained the right answers.<sup>393</sup>

In addition, the words of Raymond Einhorn, professor of accounting at American University, point out the need for substantiating the arguments for revising a system or instituting a new system:

Unless a system is acceptable to the three levels of management -- agency, executive agency, and Congressional oversight--a system will not be accepted.<sup>394</sup>

I recommend that the GAO, OMB, AICPA, et. al., provide to potential users of federal financial information, specific

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<sup>392</sup> Ibid., p. 1.

<sup>393</sup> Mautz, Robert K. "Financial Reporting: Should Government Emulate Business?" Journal of Accountancy, August 1981, p. 53.

<sup>394</sup> Einhorn, Raymond. Conversation with author, July 1990.

examples of information formats as they currently appear under the federal cash and obligation basis accounting system, and how they would appear under any proposed GAAP basis accounting system. This would entail more than simply presenting the data as currently displayed alongside the data as proposed to be displayed. To be meaningful, crossfooting and in-depth explanations should be provided of what the features of each alternative presentation would provide for management and decision-makers, as well as other external users.

I recommend that specific examples of past management decisions and the sources of information used by management to make those decisions be compared and contrasted to the type of information that would be available under any proposed revised system be presented. In this manner, the actual users of the data might be convinced that they are not currently getting all of the information they need in the format that they need it to make informed economic decisions.

#### 5. Degree of Integration Should Be Defined

As indicated earlier, virtually all literature and interviewees stated that the federal government should have an integrated structure of accounting, budgeting and reporting. To do so would solve the problem of attempting to reconcile the two major sources of financial data, the budgeting and accounting system, as well as attempting to reconcile such subsidiary accounts as plant property. The degree of integration needs to be fully defined. Such questions as whether or not it is feasible for the entire federal financial management system to be redesigned from a totally integrated standpoint, or whether the current system can be modified to allow "memorandum" type accounts to exist with a means of crossfooting to the accounting and budgeting system need to be fully explored.

#### 6. Prototypes of Proposed Reforms Should Be Developed

In the world of governmental research and development, projects involving potentially millions of dollars in federal expenditures are not permitted to progress to the production phase without demonstration of a success concept through production of a prototype. Where financial system revisions involving potentially millions of dollars of federal resources are being proposed for the entire federal government, the specific changes should not begin to be implemented without a successful prototype demonstration. In the words of the Comptroller General to Congress on the concept of the biennial budget, "We had always suggested that it be prototyped to see how

it would work."<sup>395</sup> Should we, as prudent financial managers, ask any less of a proposed revised financial management system?

#### 7. Cost/Benefit Analysis Should Be Conducted

I recommend that a cost/benefit analysis be done prior to any proposed alternative financial management systems being instituted. In this manner, before any changes are begun, all of the possible alternatives and their benefits and associated costs will have been thoroughly considered to ensure the most efficient and effective system is instituted. This will not be an easy task, as there are numerous issues to be addressed, e.g. what standards should be adopted to meet the needs of the users, what information systems must be modified or replaced, how much will the associated software and/or hardware development cost, how many hours of personnel resources are needed and will be need to be diverted from their normal duties, how much and what kind of training will be needed to educate all users on how to employ the new system in doing their job. However, cost/benefit analyses and economic analyses are required for all major weapon system purchases, and all potentially large expenditures of federal resources. With unsubstantiated estimates in the millions of dollars,<sup>396</sup> prudent financial management demands no less.

#### 8. Formal User Training on Revised Systems Should Be Developed

If any reforms are to be effective, managers and users must be educated on the composition of the revised systems and on how to use them. As indicated in the study of the Navy RMS accounting system, virtually none of the managers was aware that there was accrual data, much less how to use it. In the words of the authors:

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<sup>395</sup> U. S. Congress. House. Air Force Financial Management Systems: Hearing before the Subcommittee on Readiness. Committee on Armed Services. March 8, 1990, p. 55.

<sup>396</sup> U. S. Congress. House. Air Force Financial Management Systems: Hearing before the Subcommittee on Readiness. Committee on Armed Services. March 8, 1990, p. 14, Mr. Hutto to Mr. Bowsher, "The question in my mind, is what it will cost to implement these recommendations [author's emphasis.] It seems to me it is going to be in the hundreds of millions of dollars, more probably, in the billions. Is anyone doing a cost analysis or comparing costs to benefits to determine whether the implementation of these systems is worthwhile. Does GAO have any estimates on how much it will cost, or how long it will take to implement its recommendations?"

Therefore, if the taxpayers are to reap any benefits from accrual accounting within the Navy, at least, managers must be made aware of the system and trained in its use.<sup>397</sup>

In another example, the GAO found that implementation of the FMFIA had problems because:

about 50 percent of the managers responsible for performing the internal control assessments and evaluations have not received any training concerning the act and the work required to comply with its provisions.<sup>398</sup>

#### 9. Data Base of Good Practices<sup>399</sup> Should Be Developed

An innovative offshoot of the case study concept is proposed by William L. Kendig in an article on improving federal accounting. He suggests that since GAO is the only organization that sees the inner workings of all agencies, in addition to their emphasis on finding and correcting individual problems, they should recommend models that they come across of good operations or practices.<sup>400</sup> He suggests another approach of including two to three pages of the good features of systems under review so that other agencies could share in these practices.<sup>401 402</sup>

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<sup>397</sup> Euske, K. J., and P. W. Blondin. "Accrual Accounting in a Federal Agency." Government Accountants Journal, Fall 1985, p. 45.

<sup>398</sup> U. S. General Accounting Office. Inadequate Controls Result in Ineffective Federal Programs and Billions in Losses, Financial Integrity Act, Report to Congress, GAO/AFMD-90-10, November 1989, p. 39.

<sup>399</sup> Kendig, William L., PhD. "Solving Federal Accounting System Problems." Government Accountants Journal, Fall 1988, p. 9.

<sup>400</sup> Ibid.

<sup>401</sup> Ibid.

<sup>402</sup> Dennis Duquette of the GAO indicates that the GAO has been expanding the Discussion and Analysis (D&A) section of their audit reports to include more specific guidance to agencies of the good as well as the poor features of their systems and operations.

Duquette, Dennis, Director, Financial Audits of Civilian  
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**10. Management Reforms to Provide Flexibility and Enforceability Should Be Enacted**

GAO's Ron Young states that federal management needs to be reformed to hold the managers responsible for their performance. He suggests that executives be governed by contracts, goals and objectives to ensure competence and compliance with requirements. In addition, Mr. Young states that in order for a manager to be able to truly manage, they must have sufficient flexibility to determine how resources and services are to be used, and should be appraised and rewarded accordingly.<sup>403</sup>

**11. Due Process Should Be Followed**

Any standards set for the federal government should be subject to the same thorough treatment of accounting issues given by the FASB and GASB when setting standards and principles for the private and state/local government sectors, respectively. As GAO's Ron Young indicates:

establishing accounting standards that will effectively communicate the financial consequences of government decision-making requires study and analysis of all of the facts and circumstances pertinent to current accounting issues (e.g., legislative intent, legal requirements, financing mechanisms, funding sources, and spending mechanisms.)<sup>404</sup>

GAO issued an Exposure Draft in 1989 describing the proposed framework under which the Comptroller General would prescribe the principles and standards to implement the Budget and Accounting Procedures Act of 1950 and the Federal Managers Financial Integrity Act of 1982.<sup>405</sup> The draft proposes establishing a

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402 (...continued)

Agencies, U. S. General Accounting Office. June 27, 1990, U. S. General Accounting Office, Washington, D. C.

403 Young, Ronald S., Director, Accounting Principles and Standards Group, Accounting and Financial Management Division, U. S. General Accounting Office. June 27, 1990, U. S. General Accounting Office, Washington, D. C.

404 Young, Ronald S. "GAO's Efforts to Establish Federal "Government Accounting Standards." Government Accountants Journal, Fall 1989, p. 41.

405 U. S. General Accounting Office. Proposed Framework for Establishing Federal Government Accounting Standards, Exposure Draft, GAO/AFMD-89-56, May 1989.

Federal Government Accounting Standards Advisory Board to identify accounting issues needing resolution and to develop accounting standards. The GAO proposed composition of the board would consist of 7 members<sup>406</sup> as follows:

- Chairman, Assistant Comptroller General, Accounting and Financial Management
- OMB - 1 member
- Treasury - 1 member
- Executive Agencies - 1 member
- Academia, General Financial Community, Nonfederal accounting and auditing community - 3 members<sup>407</sup>

The exposure draft describes the due process that would be followed by the board. The process would be similar to that of both FASB<sup>408</sup> and GASB, i.e., identification of accounting issues,

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<sup>406</sup> The author understands that the current number of members now stands at 9 [Einhorn].

<sup>407</sup> In its response to the GAO Exposure Draft proposing the board for developing federal governmental accounting standards, DOD indicated the composition of the board should be: GAO - 1 member; OMB - 1 member; Treasury - 1 member; the 3 largest cabinet-level departments - 1 member each; and the remaining federal government agencies - 1 member on a rotational basis. The DOD's proposed alternative board composition reflects its position that participation should be composed entirely of representatives of the federal government.

U. S. Department of Defense, Office of the Inspector General, Memorandum for Assistant Secretary of Defense (Legislative Affairs; Public Affairs; and Fiscal and Inspector General), Subject: General Accounting Office (GAO) Exposure Draft Report, "Proposed Framework For Establishing Federal Government Accounting Standards," Dated May 1989, OSD Case 8030--Coordination of Proposed Response to GAO Draft Report, August 24, 1989, enclosure, cover letter.

<sup>408</sup> In an article on the positive aspects of the FASB in carrying out what is typified as a controversial process, Dennis R. Beresford, the chairman of the FASB, indicates that the standard setting process is designed to allow all interested parties to provide input. Beresford stresses the need for the board's independence in ensuring its credibility, and in carrying out its due process. He stresses that a trustee committee oversees the FASB operations, yet allows the board to accomplish its objective without interfering with the board's technical decisions.

Beresford, Dennis R. "What's Right With the FASB." Journal of Accountancy, January 1990, p. 82.

(continued...)

preliminary deliberations, initial document, public exposure, public hearings, consideration of comments, further deliberations, exposure draft, and final document.<sup>409</sup> The exposure draft indicates that after receiving comments on the exposure draft and public hearings, where applicable, the board would forward its recommendations to the Comptroller General. After consideration of the recommendations of the board, the Comptroller General would prescribe the principles and standards for the federal government.<sup>410</sup>

In its response to the GAO exposure draft on the federal standards board, the DOD indicated it supported the establishment of a Federal Accounting Standards Advisory Board as it would require adherence to a:

single set of governmentwide accounting standards, rather than require the Executive Branch to choose between potentially conflicting GAO Title 2 and OMB objectives, and possible, Core requirements as well.<sup>411</sup>

The DOD further stated:

The unique aspects of accounting problems associated with the federal community argues for representation from operating agencies which perform federal accounting services on a day-to-day basis. Accordingly, the Department of Defense strongly believes that cabinet-level Departments should have a greater representation on the proposed Board.<sup>412</sup>

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408 (...continued)

The author thinks this an important point to consider in the adoption of a federal standard setting board -- having an oversight committee, but allowing the board to decide based on a majority vote, what a standard or principle will be.

409 U. S. General Accounting Office. Proposed Framework for Establishing Federal Government Accounting Standards, Exposure Draft, GAO/AFMD-89-56, May 1989, p. 11.

410 Ibid., p. 14.

411 U. S. Department of Defense, Office of the Inspector General, Memorandum for Assistant Secretary of Defense (Legislative Affairs; Public Affairs; and Fiscal and Inspector General), Subject: General Accounting Office (GAO) Exposure Draft Report, "Proposed Framework For Establishing Federal Government Accounting Standards," Dated May 1989, OSD Case 8030-Coordination of Proposed Response to GAO Draft Report, August 24, 1989, enclosure, page 1.

412 Ibid.

To ensure a participatory procedure, in a final comment the DOD recommended that each board member be entitled to one vote, with a majority vote being required in order for a particular standard to be adopted.

As a final note, as this paper was in its final preparation, the author was made aware of recent developments regarding the proposed due process and federal standard setting issue. It appears that OMB is "contemplating creation of a central accounting standards board separate from GAO."<sup>413</sup> As reported by the Bureau of National Affairs (BNA), OMB's intention was disclosed at a recent meeting of the Chief Financial Officers Council.

OMB representatives would not comment to the BNA on the issue, however, the Comptroller General indicated he was told that OMB was "just trying to tidy up the standards."<sup>414</sup> The article goes on to indicate that some representatives of the Bush Administration consider GAO's role in setting standards for the Executive Branch unconstitutional. The article states that the Comptroller General indicated that the system [of GAO setting the accounting standards] was constitutional, but mentions the 1986 Supreme Court ruling which "cut GAO out of the Gramm-Rudman-Hollings system on constitutional grounds."<sup>415</sup>

As reported by the BNA, the OMB's proposed standard setting board would differ from the GAO's proposed standard setting board in that OMB's would not include the GAO on its board. In addition, while the GAO's board would rely on consensus of the members before accepting a standard, OMB's board would rely on a majority vote. Finally, the GAO board would recommend a standard to the Comptroller General, who "after considering the recommendations of the Board...would prescribe principles and standards..."<sup>416</sup> In contrast, with the OMB proposed board:

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<sup>413</sup> Bureau of National Affairs. "Government Operations: Comptroller General Says OMB Plan to Set Accounting Standards Undercuts GAO." Regulations, Economics and Law, July 12, 1990, p. A-21.

<sup>414</sup> Bureau of National Affairs. "Government Operations: Bowsher Warns Against Conflict on Setting Federal Accounting Standards." Regulations, Economics and Law, July 13, 1990, p. A-24.

<sup>415</sup> Ibid., p. A-24.

<sup>416</sup> U. S. General Accounting Office. Proposed Framework for Establishing Federal Government Accounting Standards, Exposure Draft, GAO/AFMD-89-56, May 1989, p. 14.



The OMB director, in consultation with the Treasury Secretary, would be mandated to accept the board's recommendations "unless he provides the board a written statement of his reasons for not accepting the recommendation.""<sup>417</sup>

Regardless of how the responsibility for the standard setting policy board will eventually be resolved, the primary point is that such a board is necessary to ensure all alternatives are considered, there is consensus on a particular standard, principle or approach, and there is uniformity in implementation. In the words of the Comptroller General, as quoted by the BNA:

"Bowsher also said that "the heart of the problem" is not standards or the standard setting process, but lies with "inadequate federal accounting systems and financial reporting" that has led to "numbers that are neither accurate nor timely.""<sup>418</sup>

Constructing a federal financial management system that provides data that is accurate, timely, consistent, comprehensive, and dependable for all users is the heart of the problem that must be resolved.

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<sup>417</sup> Bureau of National Affairs. "Government Operations: Bowsher Appeals to Darman to Discuss Cooperation in Setting Accounting Rules." Regulations, Economics and Law, July 20, 1990, p. A-18.

<sup>418</sup> Bureau of National Affairs. "Government Operations: Comptroller General Says OMB Plan to Set Accounting Standards Undercuts GAO." Regulations, Economics and Law, July 12, 1990, p. A-21.

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